INTERSTATE TAXATION OF DEPOSITORIES ACT OF 1977

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

S. 1900

TO CLARIFY THE TREATMENT OF BANKS AND OTHER DEPOSITORY INSTITUTIONS UNDER STATE AND LOCAL REVENUE LAWS

NOVEMBER 23, 1977

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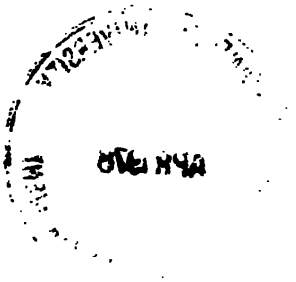

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INTERSTATE TAXATION OF DEPOSITORIES ACT OF 1977

TUESDAY, NOVEMBER 22, 1977

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
Washington, D.C.

The subcommittee met at 10 a.m., in room 5302, Dirksen Senate Office Building, Senator Thomas J. McIntyre, chairman of the subcommittee, presiding.

OPENING STATEMENT OF SENATOR McINTYRE

Senator MCINTYRE. The subcommittee will come to order.

This morning the Subcommittee on Financial Institutions continues its inquiry into the matter of State and local "doing business" taxes on out-of-State financial depositories. In March of last year the subcommittee held oversight hearings on the report of the Advisory Commission on Intergovernmental Relations. Earlier this year, on July 20, I introduced S. 1900 at the request of the American Bankers Association, the U.S. League of Savings Associations, the National Savings and Loan League, and the National Association of Mutual Savings Banks, with the understanding that this bill represents the unified approach of the financial institutions industry with regard to the underlying substantive issues of interstate taxation, particularly the jurisdiction to tax and apportionment of income.

This then is the first hearing on a specific legislative approach toward resolving issues which have been debated over a number of years. While I introduced the bill by request, I feel the bill is a reasonable and good faith effort to address the problem and my purpose in holding this hearing today is to determine whether or not the parties at interest have reached a consensus or are close enough to a consensus so Congress can take up this legislation with a view toward enacting it in this Congress.

For my part, I far prefer this approach of addressing the underlying substantive issues themselves rather than an approach which focuses on a continuation of the now-expired moratorium without attempting to resolve the substantive questions involved.

In this regard I consider the viable options at the present time to be a continuation of the status quo—that is, no Federal regulation—or the bill before us this morning, S. 1900.

At this time I would like to welcome as our first witness Mr. Matthew Hale. Mr. Hale, in your capacity as a former staff member of this

committee and subsequently counsel to the American Bankers Association, I know you have dedicated much time to consideration of the issue presented in S. 1900. Therefore, I welcome your thoughts this morning on the appropriate course of action which the Congress should take in this area at the present time. We are very happy to see you. Your statement will appear in its entirety in the record. You may testify in any manner that you please.

STATEMENT OF MATTHEW HALE, ESQ.

Mr. HALE. Thank you, Mr. Chairman.

It is a great privilege to me to be allowed to come before the committee and explain why I think action in this field is vitally important. I asked to testify as a private citizen—not on behalf of any client of the law firm with which I am associated or the ABA or anyone else—partly because of my work on the committee staff here, studying all kinds of banking problems and learning about the importance of finance and money and credit to the American economy as a whole, and the dangers of unwitting interference with the free flow of money and credit. I also worked on this particular subject for 5 or 6 years when I was general counsel of the American Bankers Association. In the course of this work, I spoke at a meeting of the National Tax Association in 1971. I have a copy of this statement here (see p. 6). I appeared before this committee with Mr. Frost in 1969, Mr. Shuford in 1972, and Mr. Bauder in 1973 when they were testifying for the ABA. I had the privilege of having been asked down to Florida at the request of Mr. Turlington, the chairman of the Committee on Finance and Taxation of the Florida House of Representatives, and of the Florida Bankers Association, to discuss the Florida tax which is the dramatic factual demonstration that this bill is necessary.

I was glad to work with Mr. Turlington later in helping him support a bill to ask the Advisory Commission on Intergovernmental Relations to study this subject, and I trust that Senator Lugar, who was a member of that Commission at the time it put out its great report, will express his views when S. 1900 gets to the full committee.

The conference report on the 1969 bill states that:

> The conferees in both houses were agreed that their respective committees would give prompt and serious consideration to any recommendations transmitted by the Federal Reserve Board as a result of its study.

This report was signed by Mr. Patman and on the conference committee were also Senator Sparkman, Senator Proxmire, Senator Williams, and Senator Tower. I hope that each and every one of those Senators will think back on this commitment, which to me was a very real one, and which frankly I think has been disregarded over the past 8 years since it was made. This is, I think, the first time that a full hearing has been held on any bill that would meet that commitment.

I think in the first place it is worth saying what the bill does not do. The bill does not say that the home State of a bank may not apply any method of taxation or any rate of taxation. A home State would only be affected by loss of a chance to tax whatever proportion of a bank's income might be allocated to another State. As far as the income a bank earns within its own home State, the home State is perfectly free to impose any kind of tax at any rate it wants within the

constitutional limitations of due process, and subject to the warnings of the Federal Reserve Board in its reports to the committee about taxes on intangibles which might cause such disintermediation as to cripple our depository system. So I think the broad general statement that banks don't pay enough taxes is irrelevant here.

During my time with this committee, and also with the ABA, I learned about the great importance of the free flow of money and credit. That is a large part of the reason for the creation of the U.S. Constitution—the expression "not worth a continental" had a very real meaning in the days of the Articles of Confederation.

Bob Fisher's book, "Banking Laws and Reports: 1780–1912", that this committee put out for its 50th anniversary, contains a lot of material which shows the importance of this money and credit to the whole economy. This committee was created in 1913 to establish the Federal Reserve System, because the leaders didn't trust the Finance Committee to handle the legislation. All through its existence, this committee has been concerned with credit for the country. The FDIC Act, insuring accounts in banks all across the country, housing credit and the Federal home loan system, farm credit. were started and developed in this committee. Small business credit, on which you had hearings yesterday, Mr. Chairman, and the credit union system, all went through this committee.

In my time here and also when I was at the ABA and served as secretary of the State bank division I came to have a very high regard for the dual banking system and for the State half of the dual banking system. I think it has given us a fragmented, competitive and very effective banking system, with correspondent banking, with automated clearinghouses, and with all the other developments in the banking system over the past 100 years. I came to have a very high regard for a great many of the State bank superintendents like Frank Wille in New York, Jim Hall in California, Freyda Koplow in Massachusetts, and Jim Faris in Indiana.

Even though a few State bank supervisors have not carried out their responsibilities, as this committee's files in the 1956 investigation of th Illinois banking situation show, the State half of the Nation's dual banking system is generally very effective, and with the help of the Conference of State Bank Supervisors and the FDIC it is constantly improving.

Even so, there are some areas where the Federal concern is clearly supreme, and one of the most important of these areas is the free flow of money and credit to all parts of the Nation, and to all parts of the economy—commerce and industry, consumers and the public generally, and the government—local, State and Federal.

Mr. Justice Holmes once said in a speech:

> I do not think the United States would come to an end if we lost our power to declare an act of Congress void. I do think the Union would be imperiled if we could not make that declaration as to the laws of several states.

I should also like to quote another expert on the subject of political relations, James Madison. I use this quotation from the Federalist because I think there are some who say "let states' rights govern it; let's not bother with a Federal statute; it's a reflection on the States to have a Federal statute." Madison said in the Federalist No. 51:

But what is government itself, but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external or internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the Government to control the governed; and in the next place oblige it to control itself. A dependence on the people is, no doubt, the primary control on the Government; but experience has taught mankind the necessity of auxiliary precautions.

That I think is what we are talking about here, a device which will control States who may intentionally or unintentionally interfere with the free flow of credit back and forth from one State to another.

We have had experience with this. I mentioned the State of Florida. During one of these intermissions in the moratorium on State taxation, Florida imposed a tax on the income from loans made in Florida by out-of-State depositories. I expect you will hear more about this particular situation from the savings bank representatives. I was invited down to Florida to testify before the Committee on Taxation and Finance of the Florida House. I have attached a copy of what I said there. If ever there was a tariff barrier erected by one State against money from outside the State, that was it.

The commitments in Florida dropped very radically, down to about a third or a quarter during the year 1972, because no responsible outside depository would want to lend money in Florida, get taxed in Florida on that income, and then bring the remaining income back to its home State and get taxed a second time. Florida frankly was out on a limb and they had these hearings. They invited us down to testify and I think Florida was delighted when the Congress took Florida off the hook with a new moratorium. But that doesn't mean that another State won't intentionally or unintentionally raise the same kind of problems, maybe not in this form but in some form.

I noticed a case in the Washington Law Reporter for July 23, 1976—a case called *Debevoise* v. *Back, et al.*—where a citizen, thinking to increase the revenues of the District of Columbia started a mandamus action against the District of Columbia requiring it to impose taxes on out-of-State banks on bank credit card business conducted in the District of Columbia. The plaintiff was thrown out because of lack of standing, but the District of Columbia taxing authorities might do this on their own initiative. Why not tax out-of-State depositories on the business they do in a State? Out-of-State depositories have very poor lobbies in any State. I regret to say it is entirely possible that banks in some State might even be willing to have out-of-State banks unable to lend in their State and thereby increase their interest rates.

So that, in one sense, I think that the present situation encourages anticompetitive tax arrangements which will keep foreign depositories out of a State, which would be bad for the public, bad for business, bad for consumer borrowers, and bad for the State government. I strongly urge the committee to live up to the commitment they made back in 1969 when they promised to give serious and prompt consideration to the recommendations of the Federal Reserve Board, which are now embodied in a bill which is satisfactory, as I understand it, to virtually the entire financial industry.

Thank you very much, Mr. Chairman, for this chance to give the committee my views. It is a little hard to put 20 years of my experience and 200 years of the country's experience into fifteen minutes, but I hope it's been helpful to you.

[Complete statement of Mr. Hale and the statement before the National Tax Association follow:]

STATEMENT OF MATTHEW HALE

I have asked—strictly as a private citizen—for an opportunity to testify on this bill, because I am convinced that federal legislation to control state taxation of out-of-state depositories is vital to our nation's monetary and financial systems, and to the free flow of money and credit to all parts of the nation and to all elements of the economy.

In the absence of such control, it is almost inevitable that state after state will, intentionally or accidentally, create tariff barriers to the flow of money and credit around the nation, and I am convinced that these interruptions to the flow of money and credit would have disastrous effects on interstate and foreign commerce, on all industrial activities, and on the government and the entire public.

In the course of working for 12 years on the staff of this committee, and for 8 years on the staff of the American Bankers Association, I have come to respect the vital importance of banking to all elements of the economy. The disastrous state of money and credit under the Articles of Confederation—"not worth a continental"—was one of the reasons for the adoption of the Constitution.

Mr. Chairman, you were a member of the Committee when we issued Bob Fisher's splendid volume—Federal Banking Laws and Reports: 1780–1912 in commemoration of the Committee's 50th anniversary. You will recall the first bank chartered by the Congress—the Bank of North America—chartered in 1781 to assist in providing 3,000,000 of rations and 300 hogsheads of rum for the use of the army. I urge you to read the book again—Hamilton's Report on a National Bank, the first and second Bank of the United States, the National Bank Act, and extracts from the Comptroller's Reports. This Committee was established to take the Federal Reserve legislation out of the hands of the Finance Committee, and the committee's work on federal deposit insurance, the Home Loan Bank System, Federal credit unions, and the beginnings of the Farm Credit system indicate the vital importance to the country of a free flow of money and credit, which is now achieved by our depository system—including commercial banks, mutual savings banks, savings and loan associations and credit unions—under a dual system of national and state depositories which give the nation a fragmented, competitive and highly effective financial system.

This dual system gives full recognition to the part which the states can play in the financial markets, and I am convinced of its benefits to the economy.

However, I am also convinced that the Federal government must exercise a measure of control over the taxes imposed by the states on out-of-state depositories.

Mr. Justice Holmes said: I do not think the United States would come to an end if we lost our power to declare an act of Congress void. I do think the Union would be imperilled if we could not make that declaration as to the laws of the several states.

The fear of state taxation which will stop loans from out-of-state depositories is not imaginary. It has happened. Florida imposed such a tax, with the result that commitments for mortgage loans by mutual savings banks dropped from $243 million in the first 6 months of 1972 to $75 million in the second six months of 1972 The Committee on Finance and Taxation of the Florida House of Representatives held a hearing on this problem, at which I had the privilege of testifying at the request of the Chairman of that Committee and the Florida Bankers Association. I have attached a copy of the statement I made at that hearing, which might be helpful to this committee.

Strong concern over the dangers of unrestricted state taxation of out-of-state depositories has been expressed by the Federal Reserve Board, and by the Advisory Commission on Intergovernmental Relations in their reports to this committee, made after extensive studies.

I am reluctant to comment on the provisions of S. 1900 or other possible solutions to this problem. What I am concerned about is not the details of the bill, but the necessity of legislation of some sort. I think the committee was well-advised to request the depositories to agree on a bill, and it seems to me that the resulting bill—S. 1900—is reasonable, fair and effective.

Accordingly, I urge the Committee to act favorably on S. 1900—with any modifications that may be found necessary—and to report it as early as possible next year.

STATEMENT OF MATTHEW HALE, AMERICAN BANKERS ASSOCIATION, BEFORE THE FLORIDA HOUSE OF REPRESENTATIVES, COMMITTEE ON FINANCE AND TAXATION, MARCH 20, 1973

Mr. HALE: Mr. Chairman and members of the Committee, Mr. Capozzola and I are delighted to be here and receive such a hospitable welcome from the Committee, from the bankers in Florida and everybody else we have met here.

I would like to make a couple of preliminary comments. First, I want to say that the appearance of the American Bankers Association at a state legislative hearing is very unusual indeed. Ordinarily, the ABA confines its legislative activities to the Congress and to national legislation. We are glad to provide advice and assistance to state bankers associations, but usually we don't appear in state legislative proceedings. We are convinced that the special banking problems in any state can best be resolved—and the point of view of the banks in the state can best be presented—by our members in the state and by the State Bankers Association. Personally, I might say that my twelve years with the Senate Banking and Currency Committee have left me with the conclusion that the legislative process is a great process and, that state governments, including particularly state legislatures, do have a most important position in the federal form of government and for that reason again we are most glad to be able to participate in this hearing.

The exception that we made here was primarily because of your invitation, Mr. Chairman, and also because the Florida Bankers Association asked us to come. Under those conditions, with a subject matter of wide importance, a ground breaking hearing like this, we felt it was most proper to accept those invitations.

Also, it seems worth commenting that the American Bankers Association, like any trade association, tries very hard to find out what its members want, and through our banker committees, through our staff, to give the best advice and information we possibly can. We know we can never get the views to everybody. We know that whatever position we take there will always be a few who do not agree with us, but again we try to do the best we can to get the best information, the best advice, to give to you as straight as we can.

We consider it a great privilege to appear before you to represent the thirteen thousand odd commercial banks, and the thousands of bankers who manage those banks, and the millions of depositors and borrowers and other customers of all those thirteen thousand banks across the country. We do feel our responsibility to the banks and to their customers very clearly.

At the risk of being presumptuous, I should also like to say that I feel that we are representing, in a sense, the United States Government, although of course we don't speak for any branch of the government or officially for the government, but I did think it would be worthwhile, in talking to you here, to point out the long, long history of the United States with Alexander Hamilton's report on a national bank and, then there was the first Bank of the United States, the second Bank, and then there was the very distressing era of free banking, so called, when every bank had to have a small telephone book at its desk to see how much discount to put on each bank note, from each state bank all across the country.

The United States has had to take over the business of supplying money as a Constitutional duty. It does it partly by making the coins you jingle in your pocket, partly by making the paper money you use, but mostly by providing in the old days bank notes; nowadays deposits in banks and checks. At the end of 1972 the Federal Reserve Board figures the money supply in the country as something like sixty billion dollars of coins and bank notes, and two hundred billion of demand deposits, which makes up the prime money supply, plus quasi money in the form of time deposits and money in savings and loans, amounting to some six hundred billion. When you add up the two hundred billion of demand deposits and the six hundred billion of quasi money, and compare that to sixty

billion dollars of coins and bank notes, clearly the United States Government is using the banking system as the principal money supply for the country—the principal payment mechanism and the principal tax collecting system. We use an unusual, special system called the dual banking system—state banks and national banks—both of which are insured by F.D.I.C. in ninety-nine cases out of one hundred, both of them working through the Federal Reserve mechanism to exchange money back and forth. Of course whenever the federal government doesn't think that the commercial banking systems is doing its job right, it creates an agricultural credit systems, or a credit union system, or a home building system—the savings and loans. One way or another the federal government is taking care of the money supply, the credit supply, of the country.

This was why back in 1964, when the National Bank Act was passed, a provision was put in limiting the states power to tax national banks. After all, the government knew that Maryland had tried to put the second Bank of the United States out of business and found it couldn't under McCulloch vs. Maryland, and as a matter of fact Congress tried to put the state banks out of business in 1865 with a prohibitive tax on state issued bank notes, which dried up state bank notes. But pretty soon deposit banking took over, so that the dual banking system ran on very effectively, with the help of the Federal Reserve System and F.D.I.C. up to the present time.

For a long time there wasn't too much trouble with the limitation on taxation of national banks. The share tax worked pretty well. Then in the early 1920's they added income taxes and franchise taxes based on income, and again for another twenty-five years things went along all right until states got to relying more and more on sales taxes. In some states, and I am told this is true in Florida, national banks went ahead and paid sales taxes anyway, whether they had to or not. And state banks, which under an equalizing statute were also exempted, went ahead and paid them too. So that as far as Florida goes, I am told, there was no loss of revenue because of the legal inability to collect sales taxes. In other states, however, there was a serious problem. There were serious inequities, and the pressure mounted until in 1969, as you have heard, when Public Law 91–156 was passed. I may say that Florida's interest at that point, as I remember, was primarily the Florida Documentary State Tax. I remember having the privilege of working with your Chairman and with Senator Holland and with Comptroller Dickinson trying to make sure that the bill that got through in 1969, took care of the Florida Documentary State Tax properly, as well as cleaning up any questions about the sales tax.

As you heard, when the Congress did pass Public Law 91–156 in 1969, they passed a temporary two year statute, later extended to three years, knowing that there might be problems in the field of intangibles, and there might be problems in the field of inter-state taxation—taxation by a state of transactions made in it by an out-of-state bank. I might say that everyone knew in 1969 that for twenty years the House Judiciary Committee and the Senate Finance Committee had been working on the problem of interstate taxation of non-financial institutions—interstate taxation of sales firms, interstate taxation of railways and airlines, interstate taxation of all kinds of transactions other than financial institutions which everybody put to one side because they were covered by section 5219 of the revised statutes. Congress asked the Federal Reserve Board to make a study of the whole subject of intangible taxation and taxation of interstate transactions. I am glad to see that there are a couple of copies of the book in which this study is printed in the Chamber here. We brought several more copies along and I wish very much the members of the Committee would each take a copy and do as much studying as they can. It is an extraordinary study. It has background papers by lawyers, by economists, by really great experts that the Federal Reserve hired; we didn't hire them, but the Federal Reserve picked out very capable experts to study all of these problems and eventually the Board came up with a report, a little bit late I am sorry to say. The Board's report and recommendations included a recommendation that if the "permanent amendment" that is now in effect, which simply says that you have got to tax national banks just the way you tax state banks—"If that provision is allowed to go into effect without revision, the changed tax status of banks might open the way for state and local tax measures that could impair the ability of the banking system and possibly the entire structure of financial intermediaries to contribute to the efficient allocation of the nation's credit resources."

This isn't ABA, this is the Federal Reserve Board speaking after a year or year and a half's study, with all this background material in front of them.

[illegible]

[illegible] The [illegible] Committee [illegible]

[illegible] technical term. The man who wants to buy a home and can't get a mortgage doesn't think it's a technical term. It is the end of his business or the end of his hope of buying a home. I don't want to go into this issue at length but I wish you would consider it carefully.

I want to spend my time primarily on the question of taxing transactions of out-of-state depositories. And here let me say that the bill that is now pending in Congress and our interest in the matter is not limited to national banks. It is not limited to commercial banks. It covers all depositories, commercial banks, savings banks and savings and loan associations, as the Federal Reserve Board recommended. These are the three kinds of depositories where disintermediation caused concern to Congress and the Federal Reserve Board; these are the three depositories which collect money from the public and channel it into useful places, especially to small businesses, individuals, home buyers, and home builders. There are two general types of issues here. The first question is what you heard described as the question of business situs or nexus, the question when a state has constitutional authority to tax the transaction. Obviously if one of you goes up to Georgia and buys something in Georgia, the state of [illegible] has very little control over that transaction. This involves the whole issue of the right of a state, the authority of a state to tax a transaction between two out of state businesses or an out of state person and a home state person. The second question is, assuming you have found a taxable transaction in a state, how much of it can the state tax, how much of it can the other state tax? Or will both states tax it fully? There are many problems. [illegible] depositories have not gotten into these problems much; Section 5219 saved them from it. National banks and state banks too have been saved from these problems. To a considerable extent state laws have made allowance for the national bank exemption and also make allowance for other state transactions by out of state savings banks and savings and loans. Fortunately for commercial banks and to a considerable extent for other depositories, the restrictions imposed by Section 5219 have freed them from the litigation and [illegible] which have burdened railroads, airlines and the mail order houses. [illegible] the history of Section 5219 has by no means been free from litigation. [illegible] the Attorney General indicated this may be an issue which is [illegible] its way up to the Supreme Court in one hundred and fifty cases.

That may be a great thing for the lawyers, but it isn't a great thing for the borrowers or the depositors of banks.

I am sure you are familiar with the savings banks that lend money in Florida. Those loans have helped Florida a great deal. In addition, I am sure that the banks of Florida have engaged in dozens—in thousands of participation loan transactions. When a Florida bank is asked for a loan bigger than its lending capacity, it may want to go to Georgia, North Carolina, Philadelphia or New York to get a correspondent bank to help in making a loan bigger than the Florida bank's own lending power will allow. And again, deposits flow back and forth—all the multiple transactions that go on in the business world—bank card systems for example—are effected in flows of money back and forth from state to state. These flows of funds are essential; they have made it necessary for the federal government to create a national banking system on occasion when there wasn't one working. The government has had to create the Federal Reserve System to make the banking system work more effectively, and to create the federal deposit insurance system to make people rely on checks and to know that a check isn't going to be bad because the bank is out of existence. In thinking of your new system of taxation of interstate transactions, I think you should consider it in the light of this flow of money back and forth. You should consider it in a fashion which will make the banking system continue to work as well as it has—we hope even better—so that nothing that you do, nothing that Oklahoma does, nothing that California does, in the way of taxing interstate transactions will set up tariff barriers between loans from an out-of-state bank to a domestic borrower or deposits by Florida individuals in a foreign bank. That's one of the principle reasons why we have a U.S. Constitution, to make sure that interstate commerce keeps running. And even if you have complete constitutional authority—or what appears to be complete constitutional authority—to go ahead and impose taxes, there is a real question whether you can, and certainly you should not, impose any taxes which will in fact tell out-of-state banks "don't lend money in Florida." Even if you have the authority, I am sure that you don't want to do it and, no other state wants to do it.

We have in ABA a task force of about a dozen bankers—Don Senterfitt was one of them—who worked for about a year trying to make up these ABA bills that we presented to Senator Bennett and asked him to introduce. The members of the task force came from all over the country—California, Washington, Chicago, New York, New Jersey, Florida and North Carolina. All of them were people with very considerable experience in banking or in banking law. And when your invitation came, Mr. Chairman, to comment on this interstate tax problem, I sent out your letter and the memorandum that came with it and the rest of the information and asked each of these task force members for their comments. I'll have to admit I didn't give them very much advance notice, but they all—except one who was out of the country—called back and all gave me their best views, at least a preliminary basis. All of them spoke very strongly about the appalling problem that could be presented if each of the fifty states, and probably the District of Columbia too, should set up a different tax system, and if a bank doing a nationwide business should have to keep its books in fifty different ways so that they could file fifty different tax returns, and then sit down with fifty different tax collectors, audit the returns fifty different times and maybe have fifty different appeal proceedings from each of the states.

You may think my figure of fifty is stretching it. I spoke to one lawyer for a bank, a relatively small midwestern bank, which only makes loans in its local market area. In connection with a holding company application the other day he checked up on where his borrowers had gone. He had borrowers in forty-two states and sixteen foreign countries. They only make loans in their own neighborhood—if that bank unexpectedly is going to have to make out forty-two sets of returns, and keep their books in forty-two different ways—the loans going to Florida one way, Oklahoma another way, New York another way, California another way—I don't know what they will do. Maybe the only answer they will come up with is to include provisions in their notes saying "This note comes due as soon as you move out of the state." It's a ridiculous thought, but I can imagine a lot of banks really finding it impossible to make up forty-two different returns on forty-two different bases; representing loans they made right in their own home town, but the borrowers moved away. This is a perfectly natural, perfectly expectable situation, but every one of these task force members felt this would probably be the worst thing that could happen to them. Frankly, most of them felt that having a uniform system of accounting, a uniform system of filing tax

[illegible]

[illegible] Florida imposes [illegible] Presently the [illegible] which is going [illegible] will provide taxes [illegible] hundred thousand dollars ($700,000), of income.

I have it under your arrangement Florida would plan to tax that seven hundred thousand dollars ($700,000), or the five percent corporate tax on the proper allocation of the figure. But New York gave up the tax which Florida is going to impose. As far as I know the New York law says a bank must include that seven hundred thousand dollars ($700,000) in its tax return. And there is nothing in New York law which says that if Florida taxes that seven hundred thousand dollars ($700,000) or half of it or any part of it the New York bank will get any break on its New York State income tax. I don't know about these New York savings banks I have heard mentioned, but if that is what is happening to them it seems to me they have every reason to take a second look at loans in any state which puts a tax on them which New York gives them no credit for.

This is the reason this is part of the reason why it is important that the problem of taxation of interstate transactions be handled in a coordinated systematic method. As I say in the non financial field people have been working on this for ten or twenty or fifty years without much success. We have not had the problem in the field of banking because under section 5219 the home state has been taxing it all. That may not be a very good form of allocation but at least it means all bank income is taxed somewhere. And for all I know New York's tax rates are higher than Florida rates, so that a bank might be glad to switch, but in any event, one way or another, all banks are taxed as fully as their home state wants them to be. If Florida is going to be permitted to tax all or part of that seven hundred thousand dollars ($700,000) interest, then New York has to give the bank making the loan an appropriate break on its income tax return.

It seems to us that the only way well, there are two ways to solve this—one with a multistate compact; as I understand it Florida did belong to the multistate tax compact for some years but has recently got out of it, I don't know just why, but apparently something was not very satisfactory. It is possible for the fifty states, in addition to the District of Columbia, to get together and agree on the question of nexus when the borrowing state have any claim—and agree on the apportionment and agree on all the forms, and the procedures,

so that everything will be standard and uniform and things will work as smoothly as they have been. The experience we have seen with the non-bank world does not lead us to believe that a multistate compact could work in the foreseeable future to prevent the kind of trouble that we have heard about in connection with the savings banks, and it seems perfectly obvious the same thing is true in the case of the commercial banks.

The other alternative, which is the alternative proposed in S. 297, is to have some central group make a recommendation, make enough of a study to provide a formula dealing with nexus and a formula dealing with apportionment and a formula covering arrangements dealing with procedures, forms and accounting methods, so that there will not be the interruption to commerce that we are very much afraid of. We originally proposed a year ago for the Federal Reserve to do it. They didn't want to do it. We again proposed the Federal Reserve this year, we thought they had done a good job before so why not try it again, but they are not in the least interested. This year the Federal Reserve recommended that either the Treasury or the Advisory Commission on Intergovernmental Relations do it and the Treasury came back and recommended that the Advisory Commission do it. Obviously ABA wouldn't be the one making the recommendation. ABA doesn't care who makes the study but I have to agree that the Advisory Commission on Intergovernmental Relations, which has Senators, Congressmen, Executive Branch Representatives, State and local Representatives and public representatives might be a very appropriate outfit to do it. Whether they would undertake it I don't know. But I can foresee that some group like that, with all interested parties represented on it, might be able to come up with a formula which might not be the one I like, which might not be the one you like, which might not be the one Oklahoma would like, but still would be good enough so that everybody could live with it in a satisfactory fashion, that would let business go on and let out-of-state banks lend in other states and let borrowers and depositors get the benefit of it.

In our proposal we recommended last year, and again this year, a further moratorium on state taxation of interstate transactions, like the interium period when states imposed a very limited number of taxes on out-of-state banks—well, actually. Mr. Chairman, we recommended a permanent moratorium and a study. Your Chairman didn't believe that was keeping the bank's feet to the fire, so he recommended a study that would be done very promptly, perhaps in a year or so, but he opposed a moratorium in the meanwhile. We recommended a moratorium so the states would not have to worry about imposing these taxes on interstate transactions in the meanwhile, but they could wait until the result of the study came out. And also, so the states would not become dependent on the taxes they were getting on these transactions, and then the formula arrived at might prevent them from taking advantage of the taxes they had been getting. Obviously it is much harder to take money away from a state that it is now getting and is dependent upon, than it is to say "Well, wait another year or another two years until the formula is arrived at." We hope that the advantages of getting a central uniform formula and system for doing this are sufficiently great so that we might be willing to wait for a year or two years for this kind of formula to be arrived at. I may say, I think we will be trying to pursuade the Congress at least to do this for a brief period, hoping that we can reach some satisfactory result.

I have mentioned one particular problem in connection with section 220, the problem of one hundred percent ceiling and how you are going to apply that to share taxes. Another point I noticed in the statute which seems to be somewhat unclear was section 220.11 which imposes a tax for the privilege of conducting business or receiving any income in the state or being a resident or citizen. It is not clear to me what is earning income in the state or what is receiving income in the state. I take it you have a ruling now which says that if an out-of-state bank makes a loan secured by a mortgage in the state that is earning income in the state. Whether that same ruling would apply to a loan in the state secured by an automobile here I am not sure. Whether it would cover a loan to a resident of Florida secured by some Government Bonds tucked away in a Chicago bank I don't know. That isn't clear to me. Or again take my case of the bank in the middle west which has forty-two (42) borrowers—borrowers in forty-two (42) states—even though it only makes local loans; suppose a borrower in Minnesota borrows five thousand dollars ($5,000) and then comes to Florida, the loan being secured by securities in stocks or bonds held in a bank in Minnesota. Is that Minnesota bank earning income in Florida because its borrower has now retired to

Florida? It doesn't seem too clear whether or not that is covered and it seems to me these things should be clear one way or another, they shouldn't be left up to litigation if it possibly can be avoided.

I mentioned the report of the Federal Reserve Board. If you look at the pages 32–35 the Federal Reserve Board discusses this issue of interstate transactions briefly and then at pages 516–541 a Professor Hellerstein of New York University made a very extensive study and report on the question of taxation of interstate transactions. I urge each of you to read it if you can, to read those two sections which will give you a real feel for the problems involved in nexus and the apportionment problems. I hesitate, following your Attorney General, to try and answer any of these questions too categorically. A lot of these questions, as I say, have not been decided in the case of banking because banking has been exempt from all these problems, but I am as sure as I am here that over the next five (5) years, if nothing is done about it, there will be dozens of cases in the Supreme Court. And in the process of taking all these cases to the Supreme Court there will be delays in lending and delays in borrowing appalling expenses for legal fees if nothing else, and just plain confusion in the banking system, interruptions to the flow of money and borrowers who can't get what they need.

I noticed at the bottom of page 521 one particular comment of Professor Hellerstein; he said, "The fluid and changing course of judicial decision in the Commerce Clause area needs to be recognized, particularly in view of the fact that four", I think actually it was three "of the nine Justices dissented in the Northwestern Stockham Valves case, and that there has been a significant change in the Court's personnel since 1959."

The conclusion I draw from that, is that nobody knows what the new Supreme Court is going to do with these issues, and quite frankly it seems to me far better for Florida and every other state to try and reach a result which will get the business done that we want to get done, without doing is the hard way by the lawsuit process.

You asked me to comment if I could on the question of apportionment. I find I made a mistake in my statement, I thought that you used the 50–25–25 formula only for banking institutions, I understand that applies to all institutions in Florida. That again brings up a problem, because as I read Mr. Ingram's chapter in his book, this formula was adopted because of Florida's role as a consumer state. When I heard Comptroller Dickinson speaking it sounded to me as if Florida might shift from that position before very long. It seems to me that if you adopt a rule because Florida is a consumer state, it is going to make it pretty hard for New York and Florida to agree on a formula. This is one of the reasons that leads me to recommend as strongly as I can that this be done by an organization like the Advisory Commission on Intergovernmental Relations, some group that can arrive at some reasonable workable formula and not have to do it by conflicting legislation which will stop loans going back and forth.

My impression of the process of government is that it is the process of accommodation of different wishes- you want one thing and I want another—if we can't agree we will have real trouble, but if we can agree on something which will work, the reaching of the workable solution is the thing that counts and not the precise nature of what the formula may be. As I say, we asked for comments from our task force and we got them from almost all of the members, their initial reactions to this request for comments at the hearing here today. I am sure that I would be getting more comments after these task force people have had more chance to look at this, and I would like very much if I might, Mr. Chairman, to have an opportunity to supply additional information. But it seems to me that the one big point that we can make without any more research than we have done is to say, "please do this in a way which would create them." Again, let us thank you very much for the privilege of coming down here and taking part in this important hearing. We hope we have been able to be of some use and if we can be of any further assistance, please let us know.

NATIONAL TAX ASSOCIATION, KANSAS CITY, MISSOURI, SEPTEMBER, 1971—REVIEW AND APPRAISAL OF FEDERAL RESERVE SYSTEM BOARD OF GOVERNORS' RECOMMENDATIONS CONCERNING COMMERCIAL BANKS

(By Matthew Hale, General Counsel, American Bankers Association)

The banking industry, like Mr. Justice Holmes, is quite aware that taxes are the price we pay for civilization. They are willing to pay this price, but they want to be treated fairly.

The banking industry, like other industries, can eventually adjust itself to a wide variety of tax structures by adjusting charges, expenses, and profits, but the process of changing from one tax structure to another can be very difficult indeed and can involve all kinds of problems for bankers and for their customers.

Over the century since the original enactment of the provision which became Section 5219, and particularly over the thirty-five years since the last substantial amendment to the provision in 1926, the banking industry became accustomed to the tax structures which were created by the various states within the framework of Section 5219 and their own constitutional provisions. One of the most significant aspects of these tax structures was that in almost every case the taxing authorities and the banking industry had made arrangements one way or another so that banks paid a fair share of taxes, as compared with other industries, so that there was equality between national banks and the state banks.

This reasonable balance between bank and nonbank taxes and this approximation to equality between state and national banks were placed under a strain in the last ten or fifteen years by the growth of several new types of state taxes—sales and use taxes, documentary stamp taxes, taxes on equipment and other tangible personal property, and motor vehicle taxes. National banks could not be required to pay these taxes, though in many states they did. However, in some other states, state banks were not given relief from these taxes, so inequality resulted. As states became more and more under pressure to raise money, and as these taxes, particularly sales taxes, became more and more important in states' tax structures, the pressure to make some changes became great.

The matter was brought to a head by national banks in Massachusetts and New York which brought suits to preserve their exemption from sales taxes which these states were trying to collect. The Massachusetts and New York Courts, in what were thought to be novel and important decisions, held that national banks were no longer Federal instrumentalities and since the exemption provided by Section 5219 depended upon this status, the exemption no longer existed and the national banks must pay these taxes. The Supreme Court, however, reversed the Massachusetts and New York cases, saying simply that as long as the Congress had not authorized the imposition of sales taxes on national banks, the states could not impose such taxes. A similar ruling was handed down with respect to a Florida documentary stamp tax early in 1969 which made things even worse. The decisions coming at a time of tight money, high interest rates, and all too often unbalanced state budgets, gave the impetus necessary to bring about legislation.

The House Banking and Currency Committee, after an informal hearing in Executive Session, reported out a bill which simply provided that national banks must pay the same taxes as state banks. This bill was passed by the House over the strenuous objection of Congressman Garry Brown of Michigan, who questioned the necessity or desirability of opening up the whole question of taxing interstate banking business and proposed an amendment which would let the home states of national banks impose the specific new taxes which were in fact sought by the states—sales and use taxes, documentary stamp taxes, taxes on equipment and other tangible personal property, and motor vehicle taxes.

The Senate revised the bill so as to provide a two-stage arrangement—an interim amendment lasting to January 1, 1972, and a so-called permanent amendment beginning on that date. Under the interim arrangement, the existing provisions of Section 5219 would be preserved and certain additional taxes could be levied by home states and foreign states under a new paragraph 5. Under the permanent amendment Section 5219 would be completely rewritten, effective January 1, 1972. After that date a national bank's home state could impose on it any non-discriminatory taxes imposed on a state bank, while foreign states could impose on national banks the same sales and use taxes, documentary stamp taxes, taxes on tangible personal property, and motor vehicle taxes. The Senate added to the bill a provision for a study by the Federal Reserve Board on the probable effects of the intangible personal property taxes imposed by the home state and the taxation of interstate business generally.

The differences between the two bills were resolved by a conference committee which followed the Senate's arrangement for interim and permanent amendments. The interim home state provision was changed by eliminating taxes on intangible personal property. The permanent amendment was changed by adopting the House language simply providing that for purposes of tax laws, a national bank shall be treated as a state bank. The Senate's savings provision was continued and also the Senate's provision for a report by the Federal Reserve Board, to be submitted by January 1, 1971, although in both cases the provisions were somewhat changed.

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Everyone was aware that the procedure was backward. The permanent amendment was to become effective January 1, 1972, and the Federal Reserve Board was directed to make a study and submit it by January 1, 1971, to determine whether the permanent law, already enacted, was good or bad. The statement of the managers on the part of the House pointed out that Congress would have a full session to study the report and to take any necessary remedial action. The statement also said, and Chairman Patman told the House that:

"The conferees from both Houses agreed that their respective committees would give swift and serious consideration to the findings and recommendations of the Federal Reserve Board."

The bill was signed into law on Christmas Eve, 1969, and the interim period began. Unfortunately, for various good and sufficient reasons, the Federal Reserve Board was unable to begin the study for several months. However, once it was started a very careful and thorough job was done. Because of the delay, the Board was not able to submit its report until May of 1971, more than four months late, and even then the many valuable backup studies were not in final shape. Consequently, the staff report and Board recommendations were issued by the Senate Committee on Banking, Housing and Urban Development as a committee print. The backup documents have not yet been made available in printed form.

Because of this delay, and also because of the press of other business, the Senate and House Committees were not able to give the swift and serious consideration to this report which Chairman Patman promised. In the light of other legislative issues before Congress, it seems clear that the issues in the report cannot be dealt with by January 1, 1972. Consequently, resolutions have been introduced in the House and Senate postponing the end of the interim period so as to give time for a review of the Board's report.

I have said the report was a careful and thorough one. I am sure that everyone who has studied the report, and even more, those who have had an opportunity to look at any of the backup papers, will agree that the report is based on a great deal of information that has never been available before, and that this new information has been carefully and thoroughly analyzed. The Board made five specific recommendations:

1. Continue without time limit the present denial of authority for states and their subdivisions to tax intangible personal property owned by national banks and extension of that denial to intangible personal property owned by state banks and other depository institutions.

2. Limit the circumstances in which national banks, state banks, and other depository institutions may be subject to income taxes on gross receipts, capital stock, or other "doing business" taxes in foreign states.

3. Prohibit discriminatory taxation of out-of-state depository institutions.

4. Amend the Federal public debt statutes to permit states to impose direct net income taxes on income from Federal Government obligations.

5. Establish a nationwide rule that coins and paper money are to be considered intangible personal property for state and local tax purposes.

Parenthetically, I should like to comment that in my judgment both coins and paper money are intangible personal property. I would define tangible personal property as items where the thing or things which make the property valuable can be touched. This would include land, buildings, furniture, equipment, and things of that sort. I would define intangible personal property as property where the thing that makes it valuable cannot be touched. This would include stocks, bonds, notes and other securities, contractual obligations, and choses in action. I can, of course, touch the paper on which a thousand dollar bond is printed, or the paper on which a one hundred share certificate of telephone stock is printed. But it is not the paper, or even the engraving, I feel, that gives the stocks or bonds their value. It is the words that are printed on them. The same is true of both paper money and U.S. coins. I can feel the beautifully engraved paper which is a new one dollar or five dollar bill. I can feel a shiny new penny or a nickel five-cent piece, or a cupro nickel dime or quarter or fifty-cent piece. But it is not the paper in the currency or the metal in the coins which gives them their value. It is Section 392 of Title 31 of the United States Code which makes all coins and currencies of the United States legal tender for all debts, public and private, public charges, taxes, and dues. When the United States issued gold coins and possibly even silver dollars, one could argue that it was the gold or silver that gave the coins their value. And once, of course, we can recall that there were silver dollars behind silver certificates and gold behind Federal Reserve Notes. But now both paper money and metal money are valuable only because they are legal tender under 31 U.S.C. 392.

It seems to me clear that when Congress wrote into P.L. 91–156 "tangible personal property (not including cash or currency)," in Section 1 and Section 3, they were doing this only to make it abundantly clear and obvious that tangible personal property did not include either cash or currency, not to change the legal interpretation which would otherwise have been given.

In its report the Board expressed serious concern that if many states should impose taxes on the intangible personal property of national or state banks, this might seriously prejudice the existence of depository institutions and might encourage bypassing such depositories, by giving an incentive to depositors to make direct loans themselves. The Board was seriously concerned as to the implications of such taxes both with respect to the future of depositories and with respect to United States Monetary functions.

The Board was also concerned by the possibility of double taxation of the income of multi-state banks. In addition, they were concerned that either by reason of double taxation or discriminatory taxation of interstate banking business the flow of funds between states and between regions might be prejudiced, to the detriment of the economic development and the economic health of the country.

These concerns of the Federal Reserve Board and its recommendations are obviously very difficult problems to resolve. The Congress has not been able to resolve the problem of interstate taxation of nonbanking business, though it has wrestled with this problem for some ten years. There is very little reason to believe that it will be easier or will take less time to resolve the problem of interstate allocation of income in the field of banking.

Banking has most of the problems of other industries and in addition has the very complicated problem of the dual banking system. So we have fifty state Constitutions, fifty state tax laws, fifty state banking codes, and the National Bank Act and the Federal tax laws. The problems of small community banks are very different from those of the giant national and international banks. The problems of holding companies, particularly interstate holding companies, are very different from those of unit banks, particularly those doing business in only one community. The problems of the major correspondent banks are different from those of their country correspondents.

Arriving at a reasonable and acceptable solution to these problems will require a vast amount of time and effort and a degree of cooperation and working together which has not so far been very apparent.

It may well be that the present interim arrangement—which at least eliminates concern as to the possible ill effects of taxation of intangible personal property and concern as to possible impediments to interstate flow of funds—may be as good a solution as will ever be reached.

In considering this problem and in trying to reach a satisfactory and acceptable solution, we must not forget that the United States needs and must have a national banking system. This does not necessarily mean a single Bank of the United States, nor does it mean a system consisting of only national banks. The dual banking system that we now have is integrated into an effective national banking system.

It was the need for a national banking system, and the complete breakdown of the state banking system during the 1860's, which made it necessary to enact the National Bank Act, and to create the National Bank system. It was the need for a national banking system which caused the enactment of the Federal Reserve Act and the Federal Deposit Insurance Act. The further development of the check clearing system, the MICR numbers and current developments along the line of automated payments mechanisms are all part of the process and all arise out of the same needs of industry, commerce, the Government, and the public.

Any tax arrangement that seriously hampers or interferes with this overriding national interest cannot last.

Senator McIntyre. Thank you. I have a few questions for you, Mr. Hale.

It appears that your statement relies largely on the experience in Florida, yet it is my understanding that Florida is not currently taxing out-of-State financial depositories.

What experience have we had with other States that would support your claim for the need for Federal legislation in this area?

And again, the two big problems they saw was the question of intangibles and the question of interestate transactions.

As you have heard also, we had a hearing last year on one bill that the ABA prepared and asked Senator Bennett to introduce—which he was polite enough to do for us; and another bill which the House Banking & Currency Committee staff drafted, both of which were designed to carry out the Board's recommendations. We did have hearings. Your Chairman came up and testified, and the ABA testified. I am sorry to say a lot of relatively unrelated provisions were inserted into the bill when it was presented to the Committees and there was really no discussion of the merits of the bill. The Congress ended in December and this so-called "permanent amendment" took effect this January.

Again Senator Bennett has been kind enough to introduce a bill for us, called S. 297, which also goes into these problems of intangibles and interstate transactions. Again we had hearings at which your Chairman appeared and the ABA appeared on the opposite side. The Committee has not yet taken any action, but that hearing was on the 28th of February, so they have not had much chance to decide whether to report a bill or not. And of course we don't know whether or not they will report a bill.

In any event the law now is that you may impose any tax which you wish on banks as long as you treat national banks the same as state banks. And that's a good provision, we have always been in favor of that. But it does leave open this question of intangibles about which Doctor Guenther has spoken to you. I don't think I need to go into the intangible question at any length, other than to say that the ABA fully agrees with the Federal Reserve Board, which took the position that they saw problems in it—especially the danger of disintermediation—driving money out of depositories into other more profitable forms of investment. We feel quite strongly about the problem of disintermediation. We have seen 1966 and the problems that small businesses, home builders and home buyers have had getting credit, getting money. While disintermediation is a long and technical sounding word, the small business who has to go out of business because he can't get credit doesn't think it's a technical term. The man who wants to buy a house and can't get a mortgage doesn't think it's a technical term. It is the end of his business or the end of his hope of buying a home. I don't want to go into this issue at length but I wish you would consider it carefully.

I want to spend my time primarily on the question of taxing transactions of out-of-state depositories. And here let me say that the bill that is now pending in Congress and our interest in the matter is not limited to national banks, it is not limited to commercial banks, it covers all depositories, commercial banks, savings banks and savings and loan associations, as the Federal Reserve Board recommended. Those are the three kinds of depositories where disintermediation caused concern to Congress and the Federal Reserve Board; those are the three depositories which collect money from the public and channel it into useful places, especially to small businesses, individuals, home buyers, and home builders. There are two general types of issues here. The first question is what you heard described as the question of business situs or nexus, the question when a state has constitutional authorty to tax the transaction. Obviously if one of you goes up to Georgia and buys something in Georgia, the State of Florida has very little control over that transaction. This involves the whole issue of the right of a state, the authority of a state to tax a transaction between two out-of-state businesses or an out-of-state person and a home-state person. The second question is, assuming you have found a *taxable* transaction in a state, how much of it can the state tax, how much of it can the other state tax? Or will both states tax it fully? There are many problems. Ever since 1864 depositories have not gotten into these problems much; Section 5219 saved them from it. National banks and state banks too—have been saved from these problems. To a considerable extent state laws have made allowance for the national bank exemption and also make allowance for other state transactions by out-of-state savings banks and savings and loans. Fortunately for commercial banks, and to a considerable extent for other depositories, the restrictions imposed by Section 5219 have freed them from the litigation and legislation which have burdened railroads, airlines and the mail order houses, though the history of Section 5219 has by no means been free from litigation. I am afraid, as the Attorney General indicated, this may be an issue which is going to work its way up to the Supreme Court in one hundred and fifty cases.

returns, a uniform system of auditing was probably more important than the method of allocation. As long as the bank pays only taxes on one hundred percent of the loan, it doesn't make a great deal of difference whether it pays it to Florida, New York, Oklahoma, Illinois, or any other state. If it has to pay more than one hundred percent that's something else again, but it isn't the amount that they were so worried about as it was the possibility of this chaos in the way of tax returns and tax procedures.

In looking over your statute I notice the provision which puts a ceiling on the amount of tax or the amount of income you count towards your tax base, designed to prevent a double tax by taxing more than one hundred percent of the income from a loan. Section 220.15 provides that if more than one hundred percent of the income from a loan is included in the basis in two or more states there will be a refund. I don't know how difficult it would be to make the showing, but if you did make the showing you would get some protection. But there are nineteen or twenty states which have bank share taxes, and about six of those have no income tax at all. Now the share tax represents exactly the same thing as the income tax. It may be bigger in any case and it may be smaller, but about twenty states have share taxes, thirty have income taxes of roughly the same amounts, and they represent taxes on the proprietor's share of the proceeds of the business in either case. But if you have a share tax nothing is included in the income. So that it seems to me in those share tax states you have a real problem to make sure you don't tax the income here and also at the bank's domicile.

I took an example of a New York bank lending ten million dollars ($10,000,000) to a Florida business firm which used the money to build a new plant. Interest on the loan might come to seven hundred thousand dollars ($700,000) a year. At the present time New York State includes this seven hundred thousand dollars ($700,000) in the New York bank's income and imposes an income tax on it. A fairly substantial income tax. So that seven hundred thousand dollars ($700,000) not only is subject to federal tax but also to a New York State Income Tax. I expect Florida imposes sales taxes on all of the things that went into the building. Probably the builder paid an income tax in Florida. Certainly, Florida is going to collect a real property tax out of the building when it is done. And the business which is going to be carried on in Florida and the resulting employment will all provide taxes for Florida, but you do have a problem about this seven hundred thousand dollars ($700,000) of income.

I take it, under your arrangement, Florida would plan to tax that seven hundred thousand dollars ($700,000) on the five percent corporate tax on the proper allocation of the figure. But will New York take off the tax which Florida is going to impose? As far as I know the New York law says a bank must include that seven hundred thousand dollars ($700,000) in its tax return. And there is nothing in New York law which says that if Florida taxes that seven hundred thousand dollars ($700,000) or half of it or any part of it, the New York bank will get any break on its New York State Income tax. I don't know about these New York savings banks I have heard mentioned, but if that is what is happening to them it seems to me they have every reason to take a second look at loans in any state which puts a tax on them which New York gives them no credit for.

This is the reason—this is part of the reason why it is important that the problem of taxation of interstate transactions be handled in a coordinated systematic method. As I say, in the non-financial field people have been working on this for ten or twenty or fifty years without much success. We have not had the problem in the field of banking because under section 5219 the home state has been taxing it all. That may not be a very good form of allocation but at least it means all bank income is taxed somewhere. And for all I know New York's tax rates are higher than Florida rates, so that a bank might be glad to switch, but in any event, one way or another, all banks are taxed as fully as their home state wants them to be. If Florida is going to be permitted to tax all or part of that seven hundred thousand dollars ($700,000) interest, then New York has to give the bank making the loan an appropriate break on its income tax return.

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Florida? It doesn't seem too clear whether or not that is covered and it seems to me those things should be clear one way or another, they shouldn't be left up to litigation if it possibly can be avoided.

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I noticed at the bottom of page 521 one particular comment of Professor Hellerstein; he said, "The fluid and changing course of judicial decision in the Commerce Clause area needs to be recognized, particularly in view of the fact that four", I think actually it was three—"of the nine Justices dissented in the Northwestern-Stockham Valves case, and that there has been a significant change in the Court's personnel since 1959."

The conclusion I draw from that, is that nobody knows what the new Supreme Court is going to do with these issues, and quite frankly it seems to me far better for Florida and every other state to try and reach a result which will get the business done that we want to get done, without doing is the hard way by the lawsuit process.

You asked me to comment if I could on the question of apportionment. I find I made a mistake in my statement, I thought that you used the 50–25–25 formula only for banking institutions, I understand that applies to all institutions in Florida. That again brings up a problem, because as I read Mr. Ingram's chapter in his book, this formula was adopted because of Florida's role as a consumer state. When I heard Comptroller Dickinson speaking it sounded to me as if Florida might shift from that position before very long. It seems to me that if you adopt a rule because Florida is a consumer state, it is going to make it pretty hard for New York and Florida to agree on a formula. This is one of the reasons that leads me to recommend as strongly as I can that this be done by an organization like the Advisory Commission on Intergovernmental Relations, some group that can arrive at some reasonable workable formula and not have to do it by conflicting legislation which will stop loans going back and forth.

My impression of the process of government is that it is the process of accommodation of different wishes—you want one thing and I want another—if we can't agree we will have real trouble, but if we can agree on something which will work, the reaching of the workable solution is the thing that counts and not the precise nature of what the formula may be. As I say, we asked for comments from our task force and we got them from almost all of the members, their initial reactions to this request for comments at the hearing here today. I am sure that I would be getting more comments after these task force people have had more chance to look at this, and I would like very much if I might, Mr. Chairman, to have an opportunity to supply additional information. But it seems to me that the one big point that we can make without any more research than we have done is to say, "please do this in a way which would create them." Again, let us thank you very much for the privilege of coming down here and taking part in this important hearing. We hope we have been able to be of some use and if we can be of any further assistance, please let us know.

NATIONAL TAX ASSOCIATION, KANSAS CITY, MISSOURI, SEPTEMBER, 1971—REVIEW AND APPRAISAL OF FEDERAL RESERVE SYSTEM BOARD OF GOVERNORS' RECOMMENDATIONS CONCERNING COMMERCIAL BANKS

(By Matthew Hale, General Counsel, American Bankers Association)

The banking industry, like Mr. Justice Holmes, is quite aware that taxes are the price we pay for civilization. They are willing to pay this price, but they want to be treated fairly.

Mr. HALE. Well, I mentioned this District of Columbia case where no tax was collected, but at least a lawsuit was started in an effort to collect.

Frankly, Senator, if I were an elected State tax collector, I would be very hesitant to allow very much time to go by if a statute was on the books authorizing me to impose a tax on out-of-state depositories. I would think the political pressure on any tax collector of that sort would be impossible to resist, and as I understand it there are quite a few States with statutes which on their face authorize collection of taxes on out-of-state depositories.

I think it's unfair to a tax collector—and unrealistic—to expect him to sit around and not collect taxes which his own statute permits him to do. He can wait a little bit. He can wait maybe a year. He can wait while he finds out whether Congress intends to live up to its commitments. But eventually I think he's going to have to collect them.

Senator MCINTYRE. There's a suggestion that credit is just another commodity and that the issue of taxation of out-of-state financial depositories should be considered in the context of taxation of out-of-state businesses of all kinds.

Is credit unique, Mr. Hale, and should we be considering this question apart from the more general question of interstate taxation of mercantile businesses?

Mr. HALE. When I was on the committee staff I, read a book called "Monetary Decisions of the Supreme Court," by Gerald Dunne. It's a fascinating little volume on the decisions of the Supreme Court on the money problem. I urge the committee and the staff to read it. There is no question that the Supreme Court considers the money power unique.

Yes, I think, money and credit are different. I think the very existence of this committee, set up to create the Federal Reserve System, demonstrates that money and credit are different. One of the principal functions of the Congress is to coin money and establish the value thereof. Most of the money that Congress has created, has coined, is in the form of bank deposits. M_1 is I think about three-fourths bank deposits. The differences between M_1 and M_2 and M_1 and M_3 consist entirely of bank deposits. I say "bank" in the broad sense, meaning depositories of all kinds.

You, the Congress, have used the banking system, the depository system, to create most of the Nation's money. Most of the money the Government collects from tax and loan accounts, most of the money that business transactions involve, most of the money that consumers use, is in the form of bank deposits. I think that's quite different from ordinary industrial business, ordinary commercial business. Certainly Congress has always treated money and credit as something separate and distinct.

Part of the background here is the fact that for over 100 years Congress has said, "Let us treat taxation of financial institutions differently from taxation of other institutions." S. 1900 really is not a new bill. Basically, what S. 1900 does is to reestablish the situation on taxation of out-of-State depositories the same way it was from 1864 to a few years ago. So I don't think you should look upon S. 1900 as a radical new change in the tax situation or in the situation with respect to taxes on financial institutions, but simply as a reinstate-

ment of a policy established in 1864 with a gap of a year or so. That's the only difference I think.

Senator McIntyre. Well, as you say, the bill is an effort to provide uniform treatment of taxation of out-of-State financial institutions, but this bill also imposes fairly stringent limitations on the ability of a given State to tax its own depository institutions.

Now, Mr. Hale, is this in any way a violation of that principle so important of states' rights?

Mr. Hale. No. I do not think so. In the first place, I do not think this bill imposes any substantial restrictions on the home state taxation of its own home State depositories. As I see it, the only thing it does is to apportion a small piece of that income or that business revenue from business which arises from out-of-State transactions. But as far as the business that 13,000 out of the 14,000 banks in the country are doing, I don't think this bill would affect the home State at all. It would leave them exactly where they are and have been for 100 years. And, again, as I said before, I do think in the field of money and credit the Federal interest is superior to the State interest, and Congress has already said so in many, many ways. I think this particular situation is an example of the need to continue an arrangement which has worked very well indeed, and where very little need has been shown to change it.

Senator McIntyre. Mr. Hale, on behalf of the Banking Committee, I appreciate very much your taking the time to come in and lead off these hearings. Your counsel is always good and we appreciate it and are grateful for it. Thank you very much, Mr. Hale.

Mr. Hale. Thank you very much, Senator.

Senator McIntyre. We call as our next witness a panel consisting of Mr. R. James Alerding, member, American Bankers Association Taxation Committee, and vice president and assistant comptroller, National Bank and Trust Company, Indianapolis, Ind.; Mr. C. James Judson, member, American Bankers Association Taxation Committee, and member, firm of Davis, Wright, Todd, Riese, and Jones, Seattle, Wash., and legal counsel, Washington Bankers Association; Mr. William Prather, general counsel, U.S. League of Savings Associations; Mr. John Krout, chairman, Federal Legislation Committee, National Association of Mutual Savings Banks, and chairman of the board, Germantown Savings Bank, Bala-Cynwyd, Pa.; accompanied by P. James Riordan, general counsel, National Association of Mutual Savings Banks.

Gentlemen, we welcome you here this morning and await your testimony. As usual we have four statements here. You go ahead and testify in the order I called you and I hope you will be able to abbreviate some parts of your statements.

Mr. Alerding.

STATEMENT OF R. JAMES ALERDING, MEMBER, AMERICAN BANKERS ASSOCIATION TAXATION COMMITTEE, AND VICE PRESIDENT AND ASSISTANT COMPTROLLER, NATIONAL BANK AND TRUST CO., INDIANAPOLIS, IND.

Mr. Alerding. Mr. Chairman, my name is R. James Alderding. I am vice president and assistant comptroller of the American Fletcher National Bank in Indianapolis, Ind. I am a member of the Taxation

Committee of the American Bankers Association, and I am accompanied by C. James Judson, Esq., a member of the firm of Davis, Wright, Todd, Riese & Jones, in Seattle, Wash., and the counsel to the Washington Bankers Association.

Mr. Chairman, on behalf of the American Bankers Association, I first wish to thank you for introducing S. 1900 and for holding these hearings.

As of today, the only Federal legislation relating to the taxation of depositories requires that the States accord the same tax treatment to federally chartered banks and savings and loan associations that is accorded State-chartered banks and mutual or thrift institutions.

The moratorium on the authority of the States to impose "doing business" taxes on the activities of out-of-State depositories provided in Public Law 93–100, as extended by Public Law 94–222, expired over 1 year ago on September 12, 1976.

Since the expiration of the most recent moratorium, few States have acted to tax out-of-State depositories. In most instances, this restraint has rested upon the anticipation that Congress would temporarily reinstate the moratorium and/or enact some type of legislation which would have made their collection efforts premature or unnecessary. However, at this time, approximately 30 States have existing legislation or regulations that could be used to tax out-of-State depositories.

If Congress further delays action, a number of States will soon begin to exercise their taxing authority. Other States will enact legislation or adopt regulations to similarly extend their taxing power. Therefore, it is imperative that Congress act at this time before the States incur administration and collection expenses and before there are any changes in State revenues which will increase the impact of any Federal legislation. The failure of Congress to act promptly will produce disequilibrium among the States and massive complexities for the depository industries.

In 1969, when Congress enacted Public Law 91–156, amending section 5219 of the revised statutes, which removed the limitation on the power of the States to impose doing business taxes on out-of-State depositories, Congress realized that it may well be exposing financial depositories to even greater controversy and disagreements than has characterized the taxation of general business corporations. As a result, Public Law 91–156 directed the Board of Governors of the Federal Reserve System to determine the probable impact on the banking system and other economic effects of this change in existing law. The Board also was asked to recommend what additional Federal legislation, if any, may be needed to balance the promotion of the economic efficiency of the financial intermediaries system with the achievement of effectiveness and local autonomy in meeting the fiscal needs of the States and their political subdivisions.

In the 700-page Federal Reserve Board report to Congress, completed in 1971, the Board concluded that additional Federal legislation was needed before the permanent amendment to section 5219 became effective, stating:

> If that provision is allowed to go into effect without revision, the changed tax status of banks may open the way for state and local tax measures that could impair the ability of the banking system and possibly the entire structure of financial intermediaries to contribute to the efficient allocation of the nation's

credit resources. Although the precise nature and magnitude of these imports are not predictable, the prospect is that they will be sufficiently detrimental to economic efficiency to warrant Congressional action (in 1971) to continue limited statutory restraints upon the taxing authorities of the states and their political subdivisions as to national banks and to apply corresponding restraints for other depository institutions.

The Federal Reserve Board went on to specifically recommend the enactment of Federal legislation that would limit the circumstances in which depository institutions may be subject to State or local doing business taxes and to prescribe uniform rules for such taxation.

In its report the Board considered that the overriding congressional legislative objective should be to avoid creation of tax impediments to the continued free flow of credit across State lines and uneconomic changes in the procedures that now govern the overwhelming bulk of interstate lending by depository institutions.

Based upon the findings of the Federal Reserve Board, Congress in 1973 enacted Public Law 93–100 which, in addition to imposing a second moratorium, directed the Advisory Commission on Intergovernmental Relations to make a study and report on all pertinent matters relating to the application of State doing business taxes on out-of-State depositories. This report was to include recommendations for legislation on "the matter of the proper allocation, apportionment or other division of tax bases and such other matters relating to the question of multi-state taxation" of depositories as the Commission should determine to be pertinent.

In 1976, the Advisory Commission on Intergovernmental Relations in its 1,000-page report recommended that Congress enact legislation which would deny authority to any State or local government to impose on an out-of-State depository a doing business tax unless the business activities or transactions within the State were based upon a substantial physical presence. Furthermore, the ACIR specifically recommended that the Federal legislation should deny taxing authority merely based upon activities to enforce a lien or otherwise protect a security interest in case of a default on a loan.

In adopting this policy recommendation for negative guidelines for jurisdiction to tax, the Commission cited as a precedent Public Law 86–272, which is the only Federal statute outside the depository area which sets limits on State taxation of interstate commerce. However, the Commission proposed that Federal legislation in the field of depository taxation "should establish a higher and more specific threshold for State assertion of jurisdiction to tax."

The Commission also recommended that Congress should declare a policy regulating interstate division of the taxable base of any depository subject to a doing business tax outside the home-office State. A corollary recommendation was that congressional legislation should provide a tax credit to limit aggregate payments to the home-office State when a depository is taxable in other States.

It is interesting to note that Senator Lugar from my home State of Indiana and a member of the Senate Committee on Banking, Housing and Urban Affairs, was Vice Chairman on the Advisory Commission on Intergovernmental Relations at the time of its deliberations on this subject. At that time he supported the need for Federal guidelines, and he supports that need now.

In summary, Congress has asked whether Federal legislation was needed if depositories were exposed to interstate taxation. In response, Congress has received two lengthy and detailed studies which clearly indicate that such legislation is needed in order to insure an efficient financial intermediary system and the maintenance of a free flow of credit in depository services.

These two studies recommended the enactment of Federal legislation providing a specific jurisdictional standard and limitations on the division of the tax base of depositories which may be taxable in other States.

Under existing law, banks, savings and loan associations and mutual savings banks pay a substantial and fair share of taxes to the State in which their principal office is located. In the absence of any need for division of base rules, these institutions pay tax on 100 percent of their income or other tax base. Most depositories would favor the continuation of a domiciliary system of taxation whereby there is full certainty of the tax consequences of their transactions and credit is free to flow across State lines without tax considerations. However, recognizing that Congress may decide that States have equitable claims to tax out-of-State depositories, the Nation's depositories join in urging the adoption of Federal legislation which will provide fair and equitable rules that define what activities of depositories support these claims and determine the share of the depository tax base attributable to nondomiciliary States.

While, in the absence of such Federal legislation, the States will strive to enact fair and equitable rules governing the taxation of out-of-State depositories, it should be recognized that we are not talking about one set of rules, but rather of 51 sets as well as the innumerable rules that may be adopted by the Nation's political subdivisions.

Accordingly, the initial concern of the financial depositories is the tremendous uncertainties that will result from their exposure to this vast array of different State and local tax rules. Therefore, the depositories seek Federal legislation which will tend to minimze the uncertanties and remove controversy and litigation that will ensue if Congress fails to act.

Any system of interstate taxation will impose greater compliance and administrative costs on depositories as they will be required to maintain multi-State records and file returns in multiple jurisdictions, both State and local. Therefore, we seek uniform rules that will reduce the administrative and recordkeeping costs of interstate taxation.

Interstate taxation will inevitably shift the taxes paid by individual depositories from their home States to other States. It may also substantially increase the taxes paid by many institutions. It can be expected that the respective States will adopt rules that will maximize their own revenues. So-called market States with few institutions likely to be taxed in other States will adopt rules that would increase the taxes that they may derive from out-of-State institutions by, for example, taxing the interest on loans according to the location of the borrower. Money center States which anticipate minimal revenue gain from out-of-State institutions would probably adopt rules that would minimize the loss of revenue base derived from their own domiciliary institutions by, for example, adopting rules which would assign interest to the office of the depository which made the loan. Therefore,

the application of these inconsistent State rules will result in individual depositories paying tax on more than 100 percent of their tax base. Moreover, if the money center States, which already tend to heavily tax their domiciliary depositories, do lose substantial revenue, they are likely to raise rates or impose new taxes on depository institutions. This political tug of war among the various States will inevitably result in an inequitable imposition of tax burden on depositories. Therefore, depositories seek Federal legislation to prevent overtaxation and to balance the interests of both market and money center States.

Some observers point to the absence of specific Federal legislation for nondepositories. In the first place, I would note that depositories are different from other businesses. While not only being the most highly regulated industry, depositories are forbidden by Federal and State law from establishing a full-scale business presence in other States. Nondepository businesses are not subject to such a major constraint. Depositories are unique in that they alone receive deposits and that they serve as financial intermediaries allocating those deposits to meet the credit needs of the Nation. I think these points were brought out well by Mr. Hale in his previous testimony. Depositories deal with credit which is a highly mobile intangible and is far different from the goods and services provided by manufacturing and mercantile corporations. Therefore, distinct considerations apply both as to the operations of depositories and their role in the economy.

The States themselves have recognized that the existing division of base rules have limited application to depositories, and that separate and distinct rules are appropriate. For instance, the Uniform Division of Income for Tax Purposes Act specifically is inapplicable to financial organizations. Therefore, for many States to exercise their authority to tax out-of-State depositories, it will be necessary for them to adopt new rules or tailor existing ones. It is within this framework that we urge the enactment of Federal guidelines which will produce the necessary uniformity but will have a minimal impact on existing State policies and revenues.

Historically, there have been over 100 years of Federal involvement in the issue of the State taxation of depositories. Therefore, we have a clear precedent for Federal legislation on this issue. Moreover, the needs for specific Federal legislation is not limited to depositories. In addition to P.L. 86–272, Federal legislation providing division of base and other rules to regularize the taxation of nondepositories has been introduced in every session of Congress since 1964.

It has been suggested by some observers that if uniformity is necessary it could be provided by the concerted action of States thereby obviating the need for any Federal legislation. The views of the States expressed before this subcommittee will clearly indicate that concerted action is improbable. Further proof lies in the fact that the States have been unable to date to develop widely accepted uniform rules for taxing mercantile and manufacturing corporations. Thus, the introduction, as we mentioned, every year since 1964 of legislation concerning that subject.

For these reasons, we have arrived at the inescapable conclusion that if we are to avoid the controversy and confusion that has characterized the taxation of nondepositories, and to maintain the efficiency

of the depository system and the free flow of credit, Congress must enact legislation providing specific jurisdiction and appropriate guidelines. We also urge that until the legislative process is completed, the moratorium on the interstate taxation on depositories be reinstated for a reasonable period and be made retroactive to September 12, 1976.

Thank you, Mr. Chairman, for allowing me to testify this morning.

[Complete statement follows:]

TESTIMONY OF R. JAMES ALERDING

ON BEHALF OF THE AMERCAN BANKERS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

OF THE

SENATE BANKING COMMITTEE

ON THE

INTERSTATE TAXATION OF FINANCIAL DEPOSITORIES

November 22, 1977

Mr. Chairman, my name is R. James Alerding. I am Vice President and Assistant Comptroller of the American Fletcher National Bank in Indianapolis, Indiana. I am a member of the Taxation Committee of the American Bankers Association and I am accompanied by C. James Judson, Esq., a member of the firm of Davis, Wright, Todd, Riese & Jones, in Seattle, Washington, and the Counsel to the Washington Bankers Association.

Once again this Subcommittee is addressing the complex and controversial issue of the interstate taxation of financial depositories. Currently, the only operative Federal legislation relating to the taxation of the depositories is 12 U.S.C. 548 and 12 U.S.C. 1464(h) which require that the states accord the same tax treatment to national banks and Federal savings and loan associations that is accorded state-chartered banks and mutual or thrift institutions. The moratorium on the authority of the states to impose "doing business" taxes on the activities of

out-of-state depositories provided in P.L. 93-100 (as extended by P.L. 94-222) expired over one year ago on September 12, 1976.

Since the expiration of the most recent moratorium, few states have acted to tax out-of-state depositories. In most instances, this restraint has rested upon the anticipation that Congress would temporarily reinstate the moratorium and/or enact some type of legislation which would have made their collection efforts premature or unnecessary. However, at this time, approximately 30 states have existing legislation or regulations that could be used to tax out-of-state depositories.

If Congress further delays action, a number of states will soon begin to exercise their taxing authority. Other states will enact legislation or adopt regulations to similarly extend their taxing power. Therefore it is imperative that Congress act at this time before the states incur administration and collection expenses and before there are any changes in state revenues which will increase the impact of any Federal legislation. The failure of Congress to act promptly will produce disequilibrium among the states and massive complexities for the depository industries.

In 1969 when Congress enacted P.L. 91-156, amending Section 5219 of the Revised Statutes, which removed the limitation on the power of the states to impose doing business taxes on out-of-state depositories, Congress realized that it may well be

exposing financial depositories to even greater controversy and disagreements than has characterized the taxation of general business corporations. As a result, P.L. 91-156 directed the Board of Governors of the Federal Reserve System to determine the probable impact on the banking system and other economic effects of this change in existing law. The Board also was asked to recommend what additional Federal legislation, if any, may be needed to balance the promotion of the economic efficiency of the financial intermediaries system with the achievement of effectiveness and local autonomy in meeting the fiscal needs of the states and their political subdivisions.

In the 700-page Federal Reserve Board Report to Congress, completed in 1971, the Board concluded that additional Federal legislation was needed before the permanent amendment to Section 5219 became effective, stating:

> If that provision is allowed to go into effect without revision, the changed tax status of banks may open the way for state and local tax measures that could impair the ability of the banking system and possibly the entire structure of financial intermediaries to contribute to the efficient allocation of the Nation's credit resources. Although the precise nature and magnitude of these imports are not predictable, the prospect is that they will be sufficiently detrimental to economic efficiency to warrant Congressional action [in 1971] to continue limited statutory restraints upon the taxing authorities of the states and their political subdivisions as to national banks and to apply corresponding restraints for other depository institutions.

The Federal Reserve Board went on to specifically recommend the enactment of Federal legislation that would limit the circumstances in which depository institutions may be subject to state or local doing business taxes and to prescribe uniform rules for such taxation.

In its report the Board considered that the overriding Congressional legislation objective should be to avoid creation of tax impediments to the continued free flow of credit across state lines and uneconomic changes in the procedures that now govern the overwhelming bulk of interstate lending by depository institutions.

Based upon the findings of the Federal Reserve Board, Congress in 1973 enacted Public Law 93-100 which, in addition to imposing a second moratorium, directed the Advisory Commission on Intergovernmental Relations (ACIR) to make a study and report on all pertinent matters relating to the application of state doing business taxes on out-of-state depositories. This report was to include recommendations for legislation on "the matter of the proper allocation, apportionment or other division of tax bases and such other matters relating to the question of multi-state taxation" of depositories as the Commission should determine to be pertinent.

In 1976, the Advisory Commission on Intergovernmental Relations in its 1000-page report recommended that Congress enact legislation which would deny authority to any state or local

government to impose on an out-of-state depository a doing business tax unless the business activities or transactions within the state was based upon a substantial physical presence. Furthermore, the ACIR specifically recommended that the Federal legislation should deny taxing authority merely based upon activities to enforce a lien or otherwise protect a security interest in case of a default on a loan.

In adopting this policy recommendation for negative guidelines for jurisdiction to tax, the Commission cited as a precedent Public Law 86-272, which is the only Federal statute outside the depository area which sets limits on state taxation of interstate commerce. However, the Commission proposed that Federal legislation in the field of depository taxation "should establish a higher and more specific threshhold for state assertion of jurisdiction to tax."

The Commission also recommended that Congress should declare a policy regulating interstate division of the taxable base of any depository subject to a doing business tax outside the home-office state. A corollary recommendation was that Congressional legislation should provide a tax credit to limit aggregate payments to the home-office state when a depository is taxable in other states.

In summary, it is clear that Congress has considered itself impelled to determine whether Federal legislation was needed to establish positive and uniform rules for interstate taxation of depositories. Congress has received two lengthy and detailed studies which clearly indicate that such legislation is needed in order to insure an efficient financial intermediary system and the maintenance of the free flow of credit and depository services. These two studies recommended the enactment of Federal legislation providing a specific jurisdictional standard and limitations on the division of the tax base of depositories which may be taxable in other states.

Under existing law, banks, savings & loan associations and mutual savings banks pay a substantial and fair share of taxes to the state in which their principal office is located. In the absence of any need for division of base rules, these institutions pay tax on 100% of their income or other tax base. Most depositories would favor the continuation of a domiciliary system of taxation whereby there is full certainty of the tax consequences of their transactions and credit is free to flow across state lines without tax considerations. However, recognizing that Congress may decide that states have equitable claims to tax out-of-state depositories, the nation's depositories join in urging the adoption of Federal legislation which will provide fair and equitable rules that define what activities of depositories support these claims and determine the share of the depository tax base attributable to nondomiciliary states.

While, in the absence of such Federal legislation, the states will strive to enact fair and equitable rules governing the taxation of out-of-state depositories, it should be recognized that we are not talking about one set of rules, but rather of 51 sets as well as the innumerable rules that may be adopted by the nation's political subdivisions.

Accordingly, the initial concern of the financial depositories is the tremendous uncertainties that will result from their exposure to this vast array of different state and local tax rules. Therefore the depositories seek Federal legislation which will tend to minimize the uncertainties and remove controversy and litigation that will ensue if Congress fails to act.

Any system of interstate taxation will impose greater compliance and administrative costs on depositories as they will be required to maintain multi-state records and file returns in multiple jurisdictions, both state and local. Therefore, we seek uniform rules that will reduce the administrative and record-keeping costs of interstate taxation.

Interstate taxation will inevitably shift the taxes paid by individual depositories from their home states to other states. It may also substantially increase the taxes paid by many institutions. It can be expected that the respective states will adopt rules that will maximize their own revenues. So-called

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"market" states with few institutions likely to be taxed in other states will adopt rules that would increase the taxes that they may derive from out-of-state institutions by, for example, taxing the interest on loans according to the location of the borrower. Money center states which anticipate minimal revenue gain from out-of-state institutions would probably adopt rules that would minimize the loss of revenue base derived from their own domiciliary institutions by, for example, adopting rules which would assign interest to the office of the depository which made the loan. Therefore, the application of these inconsistent state rules will result in individual depositories paying tax on more than 100% of their tax base. Moreover, if the money center states, which already tend to heavily tax their domiciliary depositories, do lose substantial revenue, they are likely to raise rates or impose new taxes on depository institutions. The full burden of such increased taxes will fall upon that state's institutions which conduct primarily local business and are unable to benefit through assignment of income to states with lower rates. Therefore, depositories seek to balance the interests of both market and money center states.

Some observers point to the absence of specific Federal legislation for non-depositories. In the first place, I would note that depositories are different from other businesses. While not only being the most highly regulated industry, depositories are forbidden by Federal and state law from establishing a full-scale business presence in other states. Non-depository

businesses are not subject to such a major constraint. Depositories are unique in that they alone receive deposits and that they serve as financial intermediaries allocating those deposits to meet the credit needs of the nation. Depositories deal with credit which is á highly mobile intangible and is far different from the goods and services provided by manufacturing and mercantile corporations. Therefore, distinct considerations apply both as to the operations of depositories and their role in the economy.

The states themselves have recognized that the existing division of base rules have limited application to depositories, and that separate and distinct rules are appropriate. For instance, the Uniform Division of Income for Tax Purposes Act specifically is inapplicable to financial organizations. Therefore, for many states to exercise their authority to tax out-of-state depositories, it will be necessary for them to adopt new rules or tailor existing ones.

It is within this framework that we urge the enactment of Federal guidelines which will produce the necessary uniformity but will have a minimal impact on existing state policies and revenues.

Historically, there have been over 100 years of Federal involvement in the issue of the state taxation of depositories. Therefore we have a clear precedent for Federal legislation on this issue. Moreover, the need for specific Federal legislation

is not limited to depositories. In addition to P.L. 86-272, Federal legislation providing division of base and other rules to regularize the taxation of non-depositories has been introduced in every session of Congress since 1964.

It has been suggested by some observers that if uniformity is necessary it could be provided by the concerted action of states thereby obviating the need for any Federal legislation. The states have no experience in taxing out-of-state depositories. The views expressed before this Subcommittee indicate that their interests are irreconcilable and that concerted action is impossible. Further proof lies in the fact that the states have been unable to date to develop widely accepted uniform rules for taxing mercantile and manufacturing corporations.

For these reasons, we have arrived at the inescapable conclusion that if we are to avoid the controversy and confusion that has characterized the taxation of non-depositories, and to maintain the efficiency of the depository system and the free flow of credit, Congress must enact legislation providing specific jurisdiction and appropriatory guidelines. We also urge that until the legislative process is completed, the moratorium on the interstate taxation on depositories be reinstated for a reasonable period and be made retroactive to September 12, 1976.

Senator McINTYRE. Mr. Judson.

STATEMENT OF C. JAMES JUDSON, MEMBER, AMERICAN BANKERS ASSOCIATION TAXATION COMMITTEE, AND MEMBER, FIRM OF DAVIS, WRIGHT, TODD, RIESE & JONES, SEATTLE, WASH., AND LEGAL COUNSEL, WASHINGTON BANKERS ASSOCIATION

Mr. JUDSON. Thank you, Mr. Chairman.

My name is Jim Judson. I'm a lawyer from Seattle, Wash. I am legal counsel to the Washington Bankers Association and a member of the American Bankers Association Taxation Committee. I was a member of the task force which after 2½ years of study developed the specific legislative recommendations that were contained in S. 3368, the American Bankers Association's bill on the interstate taxation of depositories which was introduced last session of Congress by Senator Sparkman.

S. 3368 represented the reconciliation of a diversity of views—geographic interests and operational considerations—within the banking industry.

[Complete statement follows:]

TESTIMONY OF C. JAMES JUDSON

ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

OF THE

SENATE BANKING COMMITTEE

ON THE

INTERSTATE TAXATION OF FINANCIAL DEPOSITORIES

November 22, 1977

Mr. Chairman, my name is C. James Judson. I am a member of the law firm of Davis, Wright, Todd, Riese & Jones, Seattle, Washington. I am legal counsel to the Washington Bankers Association. I am also a member of the American Bankers Association's Taxation Committee.

Mr. Chairman, on behalf of the ABA I want to thank you for introducing S.1900 and for scheduling these hearings.

Following the passage of P.L. 93-100, the American Bankers Association in November, 1973 established a Task Force on State Taxation to study the interstate taxation issue, to determine the views of its members and to participate in the Bank Tax Study of the ACIR. The ABA Task Force was composed of banking representatives from 20 states in order to broadly reflect the views and opinions of banks in market states and regional and national money center states; banks in states which impose different types of doing business taxes on depositories;

banks of different sizes and corporate structures and banks in states with different laws governing bank holding companies, branching, etc.

After 2 1/2 years of study, the ABA developed the specific legislative recommendations that were contained in S.3368, introduced in the 2nd Session of the 94th Congress by Senator Sparkman (by request). S. 3368 represented the reconciliation of a diversity of views, geographic interests and operational considerations within the banking industry.

In December of 1976, in response to the request of the Chairman of this Subcommittee, the ABA and the United States League of Savings Associations began discussions to attempt to reconcile the provisions of S.3368 with the legislative proposals of the U.S. League outlined in their testimony before this Subcommittee in May 1976. These discussions over a six-month period resulted in the drafting of the Interstate Taxation of Depositories Act of 1977, which was introduced by Senator McIntyre (by request) as S.1900. Before introduction, this bill was submitted to representatives of the National Association of Mutual Savings Banks and the National Savings and Loan League which joined in endorsing its provisions.

While this bill was drafted by the depository industry in an attempt to simplify the task of Congress by establishing a broad consensus and narrowing the areas of possible disagreement among the affected depositories, it should not be viewed solely

as a depository industry bill. The ABA staff and members of its Task Force directly solicited the views of a number of state tax administrators who had expressed interest in this issue. In addition, several state Bankers Associations and their member bankers met with their respective state tax administrators to determine their specific concerns. The input from the state tax administrators was considered during the drafting of this bill and their concerns were reflected throughout its structure by minimizing the changes required in existing state law and in drafting specific rules such as the provision for full accountability.

Before turning to S.1900, it would be helpful to examine several examples to demonstrate the problems that would be faced by financial institutions in the absence of uniform Federal statutory rules. The State of Florida has adopted a jurisdictional regulation which holds that the "earning or receiving of interest from loans secured by real property located in this state, irrespective of place of receipt" would be construed as conducting business within the state. The State of Oregon has ruled that an out-of-state depository would be taxable if through its agent it enters the state for the purpose of making loans and engaging in activities incidental to the making,collection and protection of such loans. If the loan were originated and serviced by an Oregon independent contractor, the depository would not be deemed to be doing

business. However, a regulation provides that an out-of-state depository will be considered to be doing business for franchise tax purposes if it acquires title to any real property secured by a loan due to foreclosures.

On the other hand, the State of California by statute provides that an out-of-state depository shall not be considered to be doing business for purposes of its tax laws by reason of the making of an appraisal or physical inspection by an employee located outside of the State, or by reason of the acquisition of title to real or personal property covered by a mortgage or security interest by foreclosure and the retention of title thereto pending orderly sale or other disposition thereof. These examples indicate the wide range of depository activities which may serve to establish taxable nexus in different states. The problems of any depository in becoming familiar with such diverse jurisdictional rules, on a state-by-state basis, would be staggering.

While few states have adopted division of base rules for depository institutions, similar diversity exists in this area. The State of Wisconsin by regulation has adopted a two-factor apportionment formula for financial institutions, composed of payroll and gross receipts, similar to that provided under S.1900. Gross receipts are assigned thereby to the State if the transaction producing the income was principally negotiated in the state. The State of Oregon has adopted a three-factor formula consisting of payroll, tangible property and gross receipts which applies to depositories. Interest income is assigned under the receipts factor to the State if

the real property on which the loan is made is located there. Other interest is assigned to the office making the loan.

Under the guidelines adopted by the California Franchise Tax Board, pursuant to the Uniform Division of Income for Tax Purposes Act, the property factor of the three-factor formula is composed of tangible and intangible property (including coin and currency). Interest income for purposes of the receipts factor and loans for purposes of the property factor are assigned to the office of the depository at which the customer applied for the loan, "except where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office in another state." Needless to say, it would be in the interest of a state for its regulatory authority to assign such out-of-state loans to an office within the state. Separate rules are provided for merchant discount and credit card receivables.

The State of Florida has a three-factor formula of payroll, tangible property and receipts. Interest from loans secured by real property are assigned to the state's receipts factor. Interest from unsecured loans (apparently including interest paid by non-Florida borrowers) if made from an office in the state, irrespective of place of receipt, or if received by offices in the state are also attributed to the state.

These examples indicate that the range of the division of tax base rules are as varied as the number of states adopting such rules. Moreover, through the resulting assignment of the

receipts from a given loan to more than one state and different weights accorded the receipts factor, over 100% of the income of the depository will be assigned to the various states. In this example, we are not dealing with hypothetical problems; rather,we are indicating the diversity and the inequity which will arise under existing laws due to the lack of Federal guidelines.

If we turn to the rules and practice governing the filing of combined tax reports, we find the same situation. California, under its unitary concept, mandates consolidation of all affiliates of a banking corporation. In Wisconsin, there is no provision for the filing of combined reports, except where required by the Department of Revenue if in its opinion they are necessary to determine taxable income or to counteract attempts to divert taxable income. In Florida a consolidated return may be elected as to affiliated corporations, but only if the parent corporation is subject to the Florida Income Tax Code. Again, the diversity in rules is clearly demonstrated, as is the possibility of over-apportionment through non-uniform combination.

In the face of this diversity and confusion, it is likely that many depositories will curtail their loans across state lines or refrain from acquiring out-of-state mortgages. Some institutions may restructure their lending practices to avoid state jurisdiction which may impair the efficiency of the banking system. Those depositories which cannot avoid exposure

will experience substantial compliance and administrative costs. These costs and higher taxes arising from inconsistent rules will be reflected in increased charges to their customers. Therefore, serious impacts on the flow of credit and the economy may arise.

In contrast, S.1900 responds to the Congressional concern for uniform and equitable methods of state taxation of depositories set forth in P.L. 93-100. Its basic legislative format is similar to that of the other bills dealing with the interstate taxation of non-financial businesses that have been introduced before Congress. Where appropriate, S.1900 adopts the same language and provides the same treatment accorded under those bills. Of course necessary changes have been made to deal with the specific problems and operations of the depository industry. I would like to briefly summarize the provisions of S.1900 and discuss how they achieve the goals of equity and fairness.

Title I of S.1900 provides a jurisdictional standard under which any state or political subdivision may tax a depository if it maintains a business location within that state or subdivision. A business location is defined in Title III of the bill as:

(1) an office location;

(2) the regular presence of employees;

(3) the leasing of taxable personal property to others;

or (4) the ownership and use of an electronic funds transfer facility.

The first three elements of this jurisdictional standard basically accord with the elements of the jurisdictional recommendations of the ACIR. The rule on electronic funds transfer, which was omitted in S.3368, follows the recommendation from the Federal Reserve Board set forth by Vice Chairman Stephen S. Gardner in his letter of June 11, 1976. Similar to P.L. 86-272, the bill specifically would exempt the solicitations of the loans which are approved outside of the state, and activities of independent contractors. Further, by providing rules exempting such incidental activities as the inspection of property, conducting appraisals, the filing and enforcing security interests, Title I establishes specific rules which should avoid the type of controversies currently engendered by P.L. 86-272. Therefore, jurisdiction is established in the case of clear and substantial activities within the state without imposing barriers to interstate credit flows.

Title II contains the optional maximum uniform apportionment formula. This formula merely serves to establish a ceiling as to the amount of the applicable tax base of a depository which may be taxed by a state which has jurisdiction to tax such a depository. This approach allows the states to adopt or continue to apply their own apportionment formulas or other division of tax base rules which providing depositories protection from taxation of more than 100% of their state tax base. If states elect to maximize their apportionment by

depositories and to reflect their own economic policy within the broad limits of its guidelines. It allows the states to tax those out-of-state institutions which have a clear presence within the state and assigns a fair measure of income or other tax base.

It eliminates trade barriers by providing the type of certainty and uniformity stressed by the Federal Reserve Board. Under the guidelines provided, a financial depository may determine whether or not to establish a taxable presence within another state; and, when it chooses to do so, a depository will be able to determine the tax burden that will flow from such presence. By providing protection for minor or insignificant activities, loans can continue to flow across state lines without tax considerations, and probable inefficient restructuring of lending practices will be avoided.

S.1900 meets the three concerns of depositories. It provides uniform rules as to jurisdiction which will serve to resolve uncertainty. By providing reasonable jurisdictional rules, depositories will not have high compliance costs in cases where the tax revenue involved will be minimal. By providing a maximum apportionment formula, S.1900 will tend to promote uniformity which will serve to reduce recordkeeping burdens. It prevents over 100% apportionment of a depository tax base and provides equitable redistribution of the depository's tax burdens among the states.

Therefore, we urge the adoption of the Interstate Taxation of Depositories Act of 1977, S.1900.

Senator McIntyre. Gentlemen, the next two witnesses I'm going to hold to a 5-minute summary. We have about a dozen questions we want to ask. We want to get your frank and honest opinion on these. We've got another panel after this. So just sum up in 5 minutes. We're going to have it all in the record, and it will be much better and a lot more interesting for me to ask question.

STATEMENT OF WILLIAM PRATHER, GENERAL COUNSEL, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. Prather. Thank you, Mr. Chairman.

My name is William Prather of Chicago, Ill. I am general counsel of the United States League of Savings Associations. I appear today on behalf of the league and its 4,400 member savings and loan associations, and also on behalf of the nearly 50 State savings and loan leagues, to present their common views on S. 1900, a bill to provide a fair, equitable, and practical apportionment formula for the State taxation of activities of financial institutions having a substantial business presence in more than one State. We suggest that with respect to this bill time is of the essence—for, the 3-year moratorium on State taxation of out-of-State financial institutions has been allowed to expire. Multistate and double taxation threaten, and the new apportionment formula is desperately needed—and soon—if complete chaos and the drying up of interstate flow of funds is to be avoided.

Mr. Chairman, we appreciate your introduction of S. 1900 at the request of the United States League, the American Bankers Association, and the National Association of Mutual Savings Banks. Our nationwide organizations have worked for 3½ years to develop this legislative recommendation.

We believe that S. 1900 provides an apportionment formula which is:

(1) The correct formula;

(2) One that is fair to the various States, political subdivisions thereof, and their taxing authorities;

(3) One that is fair to the types of financial depositories that do a substantial business in more than one State;

(4) One that considers the bookkeeping, doing business, and supervisory burdens of those many depositories which, while conducting some business in the modern world of nationwide commerce, do operate basically only in their home State;

(5) Provides a formula that allows for the full taxation of all of a depository's tax base;

(6) Provides a formula which insures that that tax base shall be taxed only once—no matter how many States are involved;

(7) Preserves autonomy to the several States and complete flexibility in the method of taxation of depositories by each State, with no forced choice of their tax patterns;

(8) Anticipates future problems and developments, makes equitable provisions for them, and thus will not become obsolete overnight;

(9) One which prohibits nondomiciliary States from imposing greater tax rates upon out-of-State depositories doing business there than upon their local depositories of the same type;

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(10) One that is practical, workable, and—while not simple—is not unduly complicated;

(11) Is one, importantly, upon which the banking business and the savings and loan business can—and do—agree; and finally,

(12) Is one that prevents a disastrous halt to the interstate flow of funds of all types, particularly funds available for home acquisition and construction.

I looked up the figures on the secondary mortgage market just before appearing here, and it's a $50 billion figure. So we are talking about a bill that is an extremely important bill. It will settle the fate of interstate taxation for almost 20,000 financial institutions with an aggregate before-tax net income of almost $14 billion at the end of 1976. The sum of their assets was nearly $1.5 trillion. Final enactment of this bill will assure that this vital secondary mortgage market will continue.

Now we have filed a general description of the bill, as have the other participants here. I won't go into that except to mention just a couple of items of significance.

The definition of business location includes the four nexus points listed by the other gentlemen, but it also lists a number of exclusionary activities which by themselves would not subject a depository to the tax jurisdiction of a nondomiciliary State.

For example, acquisition of loans or participation in the secondary market and specified collection and salvage activities with respect thereto would not create a tax nexus in a State. This specific enumeration of exclusionary activities which by themselves would not create tax nexus is designed to make it absolutely clear that those common depository activities described will not be interpreted incorrectly by any tribunal or taxing authority as coming within the four criteria which do bring an association or bank into a State.

Mr. Chairman, we believe this is an important bill. It's a timely bill, and we urge the Congress enact it in the form it was introduced.

[Complete statement follows:]

STATEMENT OF WILLIAM PRATHER
ON S. 1900

BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
OF THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

NOVEMBER 22, 1977

MR. CHAIRMAN:

My name is William Prather of Chicago, Illinois. I am General Counsel of the United States League of Savings Associations* I appear today on behalf of the League and its 4,400 member savings and loan associations, and also on behalf of the nearly 50 State Savings and Loan Leagues, to present their common views on S. 1900, a bill to provide a fair, equitable and practical apportionment formula for the state taxation of activities of financial institutions having a substantial business presence in more than one State. We suggest that with respect to this bill time is of the essence -- for, the three-year moratorium on state taxation of out-of-state financial institutions

*The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,400 savings and loan associations, representing over 98% of the assets of the savings and loan business. League membership includes all types of associations -- Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Stuart Davis, President, Beverly Hills, California; Joseph Benedict, Vice President, Worcester, Massachusetts; Lloyd Bowles, Legislative Chairman, Dallas, Texas; Norman Strunk, Executive Vice President, Chicago, Illinois; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. The General Counsel is William Prather. League headquarters are at 111 E. Wacker Drive, Chicago, Illinois 60601; and the Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006; Telephone: (202) 785-9150.

has been allowed to expire. Multi-state and double taxation threaten and the new apportionment formula is desperately needed--and soon--if complete chaos and the drying up of interstate flow of funds is to be avoided.

Mr. Chairman, we appreciate your introduction of S. 1900 at the request of the United States League, the American Bankers Association, and the National Association of Mutual Savings Banks. Our nationwide organizations have worked for three and one-half years to develop this legislative recommendation. We believe that S. 1900 provides an apportionment formula which is:

(1) the correct formula;

(2) one that is fair to the various States, political subdivisions thereof, and their taxing authorities;

(3) one that is fair to the types of financial depositories that do a substantial business in more than one State;

(4) one that considers the bookkeeping, doing business and supervisory burdens of those many depositories which, while conducting some business in the modern world of nationwide commerce, do operate basically only in their home State;

(5) provides a formula that allows for the full taxation of all of a depository's tax base;

(6) provides a formula which ensures that that tax base shall be taxed only once -- no matter how many States are involved;

(7) preserves autonomy to the several States and complete flexibility in the method of taxation of depositories by each State, with no forced choice of their tax patterns;

(8) anticipates future problems and developments, makes equitable provisions for them, and thus will not become obsolete overnight;

(9) one which prohibits non-domiciliary States from imposing greater tax rates upon out-of-state depositories doing business there than upon their local depositories of the same type;

(10) one that is practical, workable, and -- while not simple -- is not unduly complicated;

(11) is one, importantly, upon which the banking business and the savings and loan business can -- and do -- agree; and finally,

(12) is one that prevents a disastrous halt to the interstate flow of funds of all types -- particularly, funds available for home acquisition and construction.

Our fundamental objective in S. 1900 is to tax a depository once on its total tax base, and to apportion this out fairly among those States where portions of its tax base exist. We submit that the S. 1900 formula is sound, fair to business and government, objective, and above all, practical and easy to administer and enforce.

The bill and its concept are based upon full knowledge and study of the Federal Reserve Board's State bank taxation study of May, 1971, and the ACIR (the Advisory Commission on Intergovernmental Relations) study of taxation of commercial banks and thrift institutions, published in May and September, 1975. It also is grounded in the various studies of state taxation and non-depository companies engaged in interstate commerce, including the present interim statute, Title 15 U. S. Code 381, and most recently represented by a bill introduced as S. 2173 on October 4 by Senator Mathias. S. 1900 also owes much to a bill (S. 3368) introduced by Senator Sparkman in the last Congress.

S. 1900 is an important bill. It will settle the fate, interstate-tax-wise, for almost 20,000 financial depositories with an aggregate before-tax net income of $13.8 billion at the end of 1976. The sum of their assets

was nearly one and a half trillion dollars. Final enactment of the bill will assure that the vital interstate flow of home mortgage paper may continue unimpeded -- thus permitting the necessary movement of mortgage funds from areas of capital surplus to those which are capital short.

Most savings and loan associations, both State and Federal, basically do business and maintain offices and employees only in their home State, but participate actively in the nationwide mortgage market. Since the expiration of the moratorium last September, any buyer of loans and participations in the secondary market involving security property in another State or States has been vulnerable -- wide-open, in fact -- to the threat of taxation by those other jurisdictions. Only two things have partly saved the situation: one is that there are some cool heads in the state legislatures that didn't want their States labelled as greedy, money-grabbing States for the sake of 10 or 12 months' hard-to-collect revenue; and two, the hope that when Congress does act comprehensively on the matter early in the '78 session, a new moratorium retroactive to September, 1976, will be included as a part of the apportionment laws.

We filed a general description of the bill when introduced, together with a section-by-section analysis. I will refrain from duplicating this description, but would like to comment on the significance of several of its features.

The bill allows each State to define the tax base for taxing depositories, subject to certain exclusions to avoid double taxation. The bill then provides for the equitable apportionment of a depository's tax base among the various States in which it "does business" by establishing the maximum percent of that

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the chances of such depository inadvertently establishing such a tax nexus being reduced. In addition, a depository could be assured that the normal flow of money through the buying and selling of loans or interests therein in secondary market across state lines would not subject it to taxation by a non-domiciliary State.

Once a depository has chosen to come within the tax jurisdiction of a non-domiciliary State by, say, opening an office there, then it does become subject to tax there. And the loans on real estate it holds in that State (perhaps purchases in the secondary market) would be apportioned to the tax base for that State. By the same token, however, these loans would no longer be a part of the tax base for the home State.

In testimony before your Subcommittee in the 94th Congress, the U. S. League originally had recommended a simple one-factor apportionment formula based on loans. Lending, in one form or another, constitutes "substantially all" of the investments of commercial banks and savings associations and hence is a good measure of where an institution does business. Because of some reservation with respect to constitutionality, however, our recommendation has been modified subsequently to provide the more sophisticated two-factor formula contained in S. 1900. The two factors concerning how the tax base shall be divided include: 1) a "receipts factor" which means all receipts attributable to such State, related to the depositories' total receipts from all sources; and 2) a payroll factor which takes into account all compensation paid by the depository to employees located in the State, related to all compensation paid to all employees located within the United States. The two factors are given equal weight.

Thus, for example, if a Tennessee savings and loan association establishes a "business location" in Florida, thereby giving Florida jurisdiction to tax it, the percentage of its tax base that Florida could tax would be the percentage factor obtained by giving equal weight to Florida's pro rata share of the depository's total receipts from within the United States, and to Florida's pro rata share of the total compensation paid by the depository to all of its employees in the United States.

In calculating the receipts factor, all receipts from loans secured primarily by real estate are to be attributed to such participant State where the predominant part of such real estate security is located. Receipts from unsecured loans and loans secured primarily by personalty are attributed to the participant State in which such loans were originated (in effect, the State in which such loans are received for approval). All receipts from loans which might be located in non-participant States are attributed to the domiciliary State of the depository. Receipts from the sale of financial services are attributed to the State in which the service is performed; receipts from rental of tangible property are attributed to the State in which the property is located; and, receipts from securities and money market instruments are attributable to the State in which the principal trading activities are conducted.

The second factor of the two-factor apportionment formula is the payroll factor, again a fraction, the numerator of which is the total amount of

compensation paid to a depository's employees who have a regular presence in the taxing jurisdiction, and the denominator of which is the total amount of compensation paid to employees in all States by the depository during the taxable year.

As indicated earlier, the receipts factor of each participant (i.e. each State and each political subdivision in which the depository has a business location) and the payroll factor for such participant are given equal weight. This is accomplished by determining both the receipts factor and the payroll factor for such taxing jurisdiction as described above, and dividing by two. This produces the apportionment fraction for each such taxing jurisdiction which may be expressed as a percentage.

The mere use of funds transfer facilities by a depository in a non-domiciliary State would not of itself bring a depository into that state for tax jurisdiction purposes. However, if ownership were combined with use of a funds transfer terminal, terminals, switching facilities or any other tangible property involved in funds transfers in a non-domiciliary State, the combined ownership of such property and its business use would create a tax nexus. Once such nexus is created, then any extensions of credit through the use of such funds transfer facilities would constitute loans, and the receipts therefrom, together with all other receipts of the depository, become subject to apportionment to that State according to the source rules for attributing such receipts described earlier.

S. 1900 takes no position as to the propriety of the Governments'

regulating and controlling or not regulating and controlling electronic transfers of funds or other transfers of funds across State lines. We understand, Mr. Chairman, that this is not the subject addressed in your bill S. 2585, and well and should be a matter for hearings before the Subcommittee next year.) Rather, the language of S. 958 does contemplate that such funds transfers, if they do occur, shall be taxed or not taxed in a non-domiciliary State, depending upon whether a tax nexus with such State has been established and upon the source rules for attributing receipts from loans and investments as provided in the bill.

It should be emphasized that S. 958 requires no substantial change in the existing methods of taxation which individual States now apply to their depositories. It does not restrict the type of doing-business tax (net income, gross receipts or capital stock) which a State may impose on out-of-state depositories or the rates of tax which may be imposed -- provided that neither is discriminatory as compared with taxes on the same type of domestic institutions.

In summary, this bill provides a comprehensive approach to a very complex issue. It clearly defines those activities which establish State authority to tax an out-of-state depository institutions and provides equitable rules for determining the maximum amount of the depository tax base which may be assigned to a State. Within these limits, it preserves the fiscal autonomy of the States to continue existing methods of taxing depositories and to extend these rules to out-of-state institutions of like type. By removing

the uncertainties that depositories would face under diverse state systems of taxing depositories, the bill minimizes the impact of tax considerations on the interstate flow of credit, which has been a long-time concern of Congress, the Federal Reserve Board, the Federal Home Loan Bank Board, and the banking and savings and loan business.

The United States League urges Congress to enact S. 1900 in the form it has been introduced.

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OF JOHN
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Islands and the provisions of the bill should be extended to preclude taxation by that jurisdiction if this is not precluded by some constitution or treaty provision.

Thank you very much, Mr. Chairman, for the opportunity to testify in support of this bill and I do hope our suggestions as to the improvement of the language will be considered.

[Complete statement follows:]

on S. 1900
"Interstate Taxation of Depositories Act of 1977"
before the
Subcommittee on Financial Institutions
Committee on Banking, Housing, and Urban Affairs
United States Senate
November 22, 1977

My name is John E. Krout. I am Chairman of the Board and President of the Germantown Savings Bank in Bala-Cynwyd, Pennsylvania and Chairman of the Committee on Federal Legislation of the National Association of Mutual Savings Banks. I am accompanied today by Mr. P. James Riordan, General Counsel of the National Association.

I am pleased to have this opportunity to testify in support of the purposes of the "Interstate Taxation of Depositories Act of 1977" and to offer what I believe to be useful amendments.

The mutual savings bank industry is composed of 468 institutions in 17 states. The total assets of the industry are presently $144.7 billion. Of this total, $86.1 billion is invested in loans secured by mortgages on real property. Most important, for today's purposes, over $28 billion of savings bank funds are invested in mortgages, which we call "out-of-state." This means funds invested by mutual savings banks in mortgages secured by properties in states other than their domiciliary state. The Advisory Commission on Intergovernmental Relations, in its report to the Congress of June 2, 1975, on state taxation of out-of-state depositories, cites as one of the vital concerns in this area: "The preservation of national financial markets with minimum impediments to interstate and interregional flows of savings, credit, and investment."

I would respectfully submit for the record that the performance of mutual savings banks in taking part in the interregional flow of credit has been outstanding. For example, at the present time, the mutual savings bank industry, which has no institutions domiciled in California, Texas, or Florida, has invested $4.1 billion in California mortgages, it has invested $2.6 billion in Texas loans, and $2.1 billion in Florida.

This national credit fluidity, whereby mortgage funds can be channeled readily to capital shortage areas, has been stimulated over recent decades both by the federal moratorium legislation, Public Law 93-100, and by enlightened state authorities, which welcome the loans of out-of-state lenders. This realistic attitude, while it exists in most states, has not been, unfortunately, universal.

The effects on mortgage credit availability of well-motivated, but over-zealous attempts on the part of taxing states can be highlighted by a recent example. In July, 1972, the situation was much as it is today in that there was at the moment no federal moratorium statute prohibiting state taxation of non-domiciliary lending institutions on their lending activities in the taxing jurisdiction. At that time, the Department of Revenue of the State of Florida ruled that out-of-state mutual savings banks were subject to income tax on interest income received on loans secured by real property in the State of Florida, even though these loans were the only connection or "nexus" between the lender and the state.

In imposing the tax, the decision* specifically found, inter alia, that:

1. The foreign mutual savings banks' only contact with Florida arose from ownership of, and derivation of interest income,

* CITR 72-1

from debt obligations secured by mortgages on property located in Florida,

2. The foreign mutual savings banks maintained no office in Florida and had no employees located in Florida, and
3. The foreign mutual savings banks did not solicit, negotiate, or close loans in Florida.

Our National Association wrote to the Comptroller of the State of Florida at that time and expressed the deep concern of the industry, pointing out that savings banks had invested $1.9 billion in Florida mortgage loans and reminding him that this amount was more than double the amount of such loans held by savings banks 10 years earlier. The letter also asked the Florida authorities to compare this mortgage lending record of $1.9 billion by one type of non-domiciliary institution with the total mortgage lending performance of the entire Florida commercial banking industry of $2.4 billion.

Finally, in March of 1973, a hearing was held before a committee of the Florida House of Representatives. Our industry, in preparing for these hearings, had sent out a questionnaire to all savings banks asking what effect the Florida tax had on their lending policies. Out of 225 responding savings banks holding mortgage loans or commitments on Florida properties, 165 were reducing new mortgage commitments as a direct result of the tax ruling and 148 had stopped making any new Florida commitments at all. We were also able to demonstrate to the Florida legislators at that time that the estimated dollar amount of savings bank mortgage commitments on

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Florida properties dropped by 70 percent after the tax ruling went into effect - from $243 million in the first half of 1972 to only $75 million in the second half. The tax ruling of the Comptroller of the State of Florida was ultimately reversed by action of the legislature.

I cite this history as an example of the severe inhibiting effect that multi-state taxation of mortgage lenders will almost inevitably produce. Accordingly, NAMSB is pleased to support the purpose of H. 1900 insofar as it provides that no state shall have power to impose a "doing business" tax on a depository unless such depository has a "business location" in the state, as defined in the bill.

We think the draftsmen of this bill have done an excellent job with a complex problem, but, perhaps inevitably, we have what we regard as a few suggested improvements.

Section 304(a) of the bill lists certain activities which shall result in a depository being deemed to have established a "business location." Among these is where a depository regularly leases to others tangible personal property. Many savings banks extend credit through devices similar to a "sale and lease-back" arrangement, whereby lender buys the property, but leases it to borrower, typically with an option for borrower to purchase the property at the end of the lease term. Since this is merely a lending technique in the form of a lease, it is suggested that the interregional flow of credit would be aided by an amendment to this section which might read: "tangible real or personal property located in such state, except where such lease is incidental to a lending agreement between lessor and lessee."

In Section 304 (b)(4) of the bill, it is provided that a depository shall not be deemed to have a business location within a state merely by the holding, rental, maintenance, operation, etc. of foreclosed property; provided that such depository shall pay real estate taxes on the foreclosed property and shall not hold, own or operate such property for a period of 5 years from the final date of its acquisition.

The acquisition of title to foreclosed property by a lending institution is never a happy event and the lending institution typically does not hold and operate the property as anything but a nuisance necessary to the preservation of its interest. There are occasions, however, where a mortgage lender holding property acquired through foreclosure can not dispose of it at a reasonable price and must, against all preferences, continue to hold the property. The 5 year limitation could therefore be most undesirable. We would suggest that after the 5 year period provision in the bill, there be inserted language along the following lines: "provided, however, that foreclosed properties may be held for a longer period so long as they are offered for sale for an amount not exceeding the cost of acquiring, improving, and operating such property, including legal fees, taxes and such other amounts as are advanced to protect the security."

Where a state acquires jurisdiction to tax an out-of-state lender solely by virtue of the lenders operation of foreclosed properties it should not be able to tax the institution on its entire mortgage portfolio in the state by some apportionment formula. We are concerned that the proposed bill could be so interpreted. We would suggest language that the

acquisition of jurisdiction by virtue of the operation of foreclosed properties should grant the taxing state the authority "only to tax, on a separate accounting basis, the net income realized in connection with the ownership, operation and sale of foreclosed properties without application of any apportionment formula whatsoever."

In commenting on the above suggestions relating to foreclosed properties, the report of the Advisory Commission stated: "The Commission sees merit in the objectives of the proposed additional specifications, but it takes no formal position concerning the particular suggestions.... The Commission recommendation is not intended to preclude a narrowly limited jurisdiction over particular localized operations or transactions, such as, for example, a net income tax determined by separate accounting and confined to income derived from the operation of foreclosed properties."

Among the other activities which Section 304(b) provides shall not be deemed to establish a "business location" is the acquisition or purchase of loans from one or more independent contractors having a business location in that state. We would like to add to Section 304(b)(1) the phrase: "or the physical inspection and appraisals of real or personal property in such state securing any loans or proposed to secure any loans." This language would parallel the similar language contained in Section 304(b)(2), which seems limited to the activities of the independent contractors having a business location in the state, and not to the out-of-state lender, who might well wish to conduct an independent appraisal.

The term "independent contractor" is defined in Section 304(b)(5) as a person or organization "engaged in business activities on behalf of more than one principal." It would seem to be at least hypothetically possible that a contractor, otherwise completely independent, might have at some period in time an client other than one out-of-state lender. The definition, therefore, might more appropriately be amended to read: "which such person or entity holds himself or itself out as an independent contractor in the regular course of business."

Section 306 provides tests for determination of when an "employee" shall be considered to be located in a state or to have a regular presence there. One of the tests in Section 306(a)(3) is that "location" or "regular presence" will be found if some of the employee services are performed in the state and the "base of operations" or base from which the employee's service is directed or controlled is in the state. It is difficult to understand what the draftsmen had in mind regarding this "base of operations", which seems to be neither residence nor business office. This section might be clarified.

Finally, Section 309 defines "State" so as to exclude jurisdictions such as the Virgin Islands. Consideration of the advisability of this exclusion might be useful.

I very much appreciate this opportunity to appear on behalf of S. 1900.

Senator McIntyre. Well, they certainly will.

Now I will ask these questions and I want a comment from each one of you and we will follow that same order—Alerding, Judson, Prather, and Krout.

Gentlemen, how would you characterize the magnitude of the problem you suggest? In the absence of Federal legislation, what is likely to happen? How many banks, for example, would be involved in complying with a multiplicity of taxes? What is the general size of these banks? In other words, are we talking of relatively few large institutions or is the problem more general in scope?

Mr. Alerding. Mr. Chairman, I think Indiana presents a very good example of what might happen in the rest of the country. We have a lot of what we call border banks in the State of Indiana. We have approximately 410 banks and I would estimate that anywhere up to 200 of those banks do business in bordering States—Michigan, Ohio, Illniois, and Kentucky. All of those States have very active revenue departments, Kentucky in particular, and it is not an issue which is restricted to smaller institutions. It in fact ranges from smaller to the very largest of institutions, primarily again because of the border situation.

So you may have a bank sitting in Fort Wayne which is approximately 20 miles from the Ohio border and it may have depositors and customers in Ohio. This bank is going to find itself in a rather difficult situation one day when the Ohio tax authorities show up and begin asking questions and ask for returns to be filed and things of this nature.

So I believe that it is a very serious question for all the banks—the smaller banks, of course, do not have the capabilities and the financial resources to deal with the problem as we in the larger banks do.

As to the second part of the question, I think you will find some restrictive flows of credit. For instance, in our own situation we would very likely prepare an analysis that would indicate the type of yield that we would need to obtain from a loan made in any State outside of the State of Indiana, and we would be able to establish a rate structure for each of the 50 States and the District of Columbia that would tell us what it is that we have to make a loan at in Arkansas in order to make what we consider to be our acceptable yield.

So I think you will find money restricted as to its flow from one State to the other depending on what the State tax method might be.

Senator McIntyre. Mr. Prather, what are the size of these banks that he's talking about? Give me the size of them.

Mr. Prather. I really don't think it's a question of the large versus the small institution in this case, Senator. In the savings and loan business, as you know, most of our institutions are quite small, localized institutions and basically they do business at home in their home State. However, in the secondary mortgage market one small institution located in Peoria, Ill. could be doing business, theoretically, in 12 or 15 States simply by buying loan participations and holding loans from people in several other States. This means that without this bill they would have to file and become domesticated and possibly pay taxes in all 12 of these various States. It would be a huge headache.

Senator McIntyre. Mr. Prather, supposing we slapped a prohibition—a moratorium on taxing the secondary mortgage market so we won't allow the banks to be taxed in a situation where you pick up a bundle of secondary mortgages and you've got 15 States involved. Would that be a good idea? Just delete that from any taxation by any State.

Mr. Prather. Well, the only answer I have to that, Senator, is that the moratorium has worked. It has preserved the secondary mortgage market (and that's all that's preserved it) in the threat of what's facing us:

Senator McIntyre. Mr. Krout, how large are the banks? Are all the banks involved? I notice the Independent Bankers Association is not here to tell us how they feel about this issue so they can't be overly interested. We hear a lot from them on the NOW accounts, though.

Mr. Krout. I can't speak for the Independent Bankers. I can speak for the savings banks. As indicated in my testimony, we have almost 500 savings banks and a third of our mortgage investments are in other States. My particular bank is number thirty. It's the 30th largest savings bank, which isn't large. It's about a billion dollars in assets. We have mortgage loans I think in about 25 States throughout the country. Any elimination of the protection that we have had against taxation by these States would be a serious threat to our ability to lend these funds to the advantage of our depositors.

I don't think in our industry at least it's a big bank question because many smaller savings banks are involved in the secondary mortgage market and, on the prior comment, the term secondary mortgage market is a very hard term to define. Many loans I think are made by savings banks that are not really made in the secondary market. They are made through an independent contractor in another State but the loan has been made based on the savings bank's commitment of its dollars in the very first place and I don't think it's technically a secondary mortgage market loan. So I think it would be difficult to arrive at a definition of secondary mortgage market as a way of eliminating the problem.

[The following letter was received for the record:]

National Association of Mutual Savings Banks,

New York, N.Y., December 16, 1977.

Hon. Thomas J. McIntyre,
Chairman, Subcommittee on Financial Institutions, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

Dear Mr. Chairman: You will recall that at the recent hearings on S. 1900, the savings bank industry was represented by John E. Krout, Chairman of the Board and President of the Germantown Savings Bank in Bala-Cynwyd, Pennsylvania.

In the course of the testimony you questioned Mr. Krout as to whether small banks as well as large banks are typically involved in out-of-state lending. In this regard, you observed: "I notice the Independent Bankers Association is not here to tell us how they feel about this issue, so they can't be overly interested." (page 36 of the transcript)

Mr. Krout then made an offer to provide statistics on this point, saying: "Mr. Chairman, could I volunteer to provide the Committee with a breakdown of savings bank investments which will show you banks by size and the extent of out-of-state investment importance to the banks to show that many small banks are involved in this area?" (page 38 of the transcript)

In pursuance of Mr. Krout's undertaking, the Research Department of NAMSB has prepared the attached chart entitled: "Number of Mutual Savings Banks

Holding Out-of-State Mortgages, by Deposit Size, September 30, 1976." If there is still time, I would appreciate insertion of this in the record of the hearings.

Thank you for the opportunity to comment.

Sincerely,

P. JAMES RIORDAN, *General Counsel.*

NUMBER OF MUTUAL SAVINGS BANKS HOLDING OUT-OF-STATE MORTGAGES, BY DEPOSIT SIZE, SEPT. 30, 1976

Deposit size (millions)	Number of savings banks		
	Total	Holding out-of-State mortgages	Number of banks holding out-of-State mortgages as percent of total
Under $50	129	79	61.2
$50 to $74.9	80	65	81.3
$75 to $99.9	47	40	85.1
$100 to $249.9	104	98	94.2
$250 to $499.9	52	47	90.4
$500 to $749.9	20	20	100.0
$750 to $999.9	14	14	100.0
$1,000 to $1,999.9	21	21	100.0
$2,000 and over	6	6	100.0
All savings banks	473	390	82.5

Source: National Association of Mutual Savings Banks.

Senator MCINTYRE. I think all I wanted to know is what is a large bank.

Mr. JUDSON. Mr. Chairman, if I may respond to that, taking two points of view. First of all, in my home State of Washington, most banks are quite small. There are only two banks with assets in excess of $1 billion. The rest of the 100 or so banks range down to $10 or $20 million of assets. Those banks are equally concerned with this problem as are the two medium-sized banks in the State of Washington. There are banks on the border which have loans back and forth across the border with Oregon and Idaho. There are banks which do business through car leasing or through auto loans to people who change their jobs and move to another State. Some of the smaller banks have estimated that they have loans in 10 or 20 other States simply due to this moving of borrowers and to the presence of mortgage loans in other States.

Second, let me stress that although the American Bankers Association consists of both large and small banks, it does represent most of the independent bankers. Of the 14,000 or so commercial banks in the United States, 92 percent are members of the American Bankers Association, including the independent bankers.

Mr. KROUT. Mr. Chairman, could I volunter to provide the committee with a breakdown of savings bank investments which will show you banks by size and the extent of out-of-State investments importance to the banks to show that many, many small banks are involved in this area?

Senator MCINTYRE. The location, as Mr. Judson said, could have some effect on that. It could be on the border.

Mr. KROUT. That would be part of the problem, but really it's a capital shortage problem where the banks are going all over the country to invest their funds.

Senator MCINTYRE. Well, I will ask this question in this order: Mr. Krout, Mr. Prather, Mr. Judson, Mr. Alerding.

What has been the activity of various States to date? The moratorium expired in September of last year and I'm not aware that any States are currently taxing out-of-State depositories. What is a reasonable expectation if this or other Federal legislation were not to be enacted? What's the reasonable expectation? Is this thing really going to start to boil?

Mr. KROUT. I think you just have to speculate in this area that the States have been holding back because of the fact that they have been precluded from this area for such a long time and they realize that the legislation is currently being considered to either extend the moratorium or adopt a piece of legislation like S. 1900 which would delineate the rules. I cannot say that we have any current threat in any State but I think that is largely dictated by the current legislative atmosphere in Washington.

Mr. PRATHER. I think the only reason the various States, including Florida, have held back is simply because of the threat that this bill, S. 1900, is going through. They know that a moratorium probably will be made retroactive and for, say, a year or 2 years' worth of hard-to-collect income from going after the out-of-State institutions they probably felt it wasn't worth it, at the same time ruining the reputation of their State in the secondary market and being known as a money-grubbing State.

Senator MCINTYRE. Are there any different opinions?

Mr. JUDSON. Let me make one additional comment. That is, we don't really have a tax return period yet that has passed, since the moratorium lapsed. The current tax year has not yet ended, nor has any fiscal year which started on or after the September 12 date last year; so we don't have a tax return period yet. The fact that States haven't sought to tax too many institutions is indicative, I think, only of that.

Mr. ALERDING. Senator, we have had in our bank an employee from the State of Tennessee asking for tax information regarding the bank. We have also had an employee from the State of Kentucky who was in a year ago shortly after the expiration of the moratorium performing an audit on our nonbank affiliates, but an unusual amount of time was spent on the banking orgazination and on building a case toward a unitary taxation method in anticipation of this.

Senator MCINTYRE. All right. Let me ask this question.

Mr. Judson, Mr. Alerding, Mr. Prather, and Mr. Krout, after the first witness has spoken all I want from the others is additional comment or a difference of opinion.

Gentlemen, your positions are very well stated in the testimony and the legislation you have proposed. I'm curious. The Advisory Commission on Intergovernmental Relations endorsed the concept of negative guidelines whereby there should be certain restrictions on the State's ability to tax but that the States should not be required to standardize their tax policies.

Now, doesn't this bill, in an attempt to standardize national treatment of taxation of out-of-State depositories, also impose substantive restrictions on the ability of States to tax their own domestic banks and isn't this to that extent an unwarranted intrusion on States' rights in this matter?

Mr. JUDSON. Let me say first of all that there are very few restrictions on the rights of domiciliary States to tax their own banks. The primary one has to do with the uniform apportionment formula which is provided for in the bill. That simply provides a maximum beyond which a home State may not go in the taxation of its home State banks. There is no substantive restriction on the right of a home State to tax its own banks, whether it be by virtue of the method of taxation or the tax base or anything else.

Let me pause to comment on just one additional restriction having to do with the tax base. Income earned by foreign offices and foreign branches is excluded. Other than that, I think those are the only two restrictions and they are provided in the interest of uniformity and equity for determining the tax base apportionable to a home State.

Senator MCINTYRE. They are not unwarranted then?

Mr. JUDSON. No; I think not.

Senator MCINTYRE. Any disagreements or agreements?

Mr. ALERDING. Just an additional comment that the maximum apportionment formula is in effect a negative guideline that allows the States to do whatever they wish but not to exceed the maximum allocation formula which is equitable.

Mr. PRATHER. I agree.

Senator MCINTYRE. It has been suggested, gentlemen, that the tax treatment for banks contained in this bill represents, in effect, preferential treatment and that to this extent depositories are given a competitive advantage not available to other kinds of nondepository competitors. This is particularly true in States which use other than a two-factor formula.

How would you respond to this assertion, Mr. Krout?.

Mr. KROUT. Well, I think that your question is somewhat related to the question you asked the first witness as to whether money is different from other commodities. I think it is different because it's a medium of exchange. It's not a commodity and there's no way that this country or States which are short of capital over the years could have acquired the capital necessary for their growth if it hadn't been for the free flow of money and loans into those States.

So I think you can clearly distinguish between money which is a medium of exchange and commodities which are really goods and services which are purchased with money.

Mr. PRATHER. There's nothing I can add to that.

Mr. ALERDING. The only thing I would say is that the only way we could be considered as having a competitive disadvantage, since we consider this to be an equitable tax treatment among the States, is if you assume there's an inequitable tax treatment of nondepositary businesses in various States.

Mr. JUDSON. Let me add, also, that other institutions are not subject to restrictions that financial institutions are. They can freely branch, freely cross State lines, establish offices with employees and plants wherever they wish, and they have to bear the tax burdens of those decisions. Banks do not have that right, and so there is a difference between us and most other institutions.

Senator McIntyre. My next question, Mr. Judson, Mr. Alerding, Mr. Prather, and Mr. Krout, is what is there in this bill to guarantee, as the ACIR recommended, a policy of nondiscrimination; that is, a policy that insures out-of-State depositories are not taxed higher than domestic depositories by any given State?

Mr. Judson. Title III, part B contains a specific provision to that effect. I think it provides the guarantees that are required.

Mr. Prather. It's very specific.

Senator McIntyre. Mr. Krout, Mr. Prather, Mr. Judson, gentlemen, much has been said about the impact of tax barriers on impeding the free flow of credit. Is this a real concern? Or isn't it reasonable to assume financial institutions, like other businesses, will engage in profitable activities whenever and wherever they may be located, and accept the tax consequences? Why won't banks follow where profits lead them? Are these so-called tax barriers a real concern?

Mr. Prather. I think the nugget of the answer was in your question, Senator. When an institution becomes so heavily subject to tax in another State, twice, perhaps three times, the profit motive vanishes. It is not profitable to do business where you are taxed two or three times. So hence people will not go into the other State, they will stay at home.

Mr. Judson. The area which is most susceptible of termination because of this problem is small loans, automobile loans, auto leases, that kind of thing. We have seen in the past that auto loans and auto leases have provisions requiring acceleration of the loan if the car or other collateral is taken to another State. It may affect the security interest of the bank with the car 1,000 miles away.

There could be a similar provision that would give rise to a forfeiture or termination for tax reasons. This is not unlikely, particularly in the small consumer loan area.

Mr. Alerding. I would add, Senator, another problem area for commercial banks involves correspondent banking relationships, and particularly the flow of Federal funds across State lines. The Federal fund system is like a large national power grid to begin with, in the sense it is a house of cards, or set of dominoes, and there could be some disorientation in that area that could be rather serious.

Senator McIntyre. Mr. Judson, can you generalize as to how this bill and where this bill materially departs from the recommendations of the ACIR?

Mr. Judson. Well, I think the basic difference is that the ACIR's recommendation was just that, a statement of policy with respect to the jurisdictional standard and a negative guideline. It did not contain the degree of specificity required.

In addition, there was no method of division of the tax base, and this bill, of course, provides for an option, a maximum, rather, with respect to this. Those are the two basic differences between this bill and the ACIR recommendation.

Senator McIntyre. Let me ask the balance of the panel here, given the jurisdictional standard of S. 1900, do you consider the threshold established to be consistent with what the ACIR recommended? Mr. Krout?

Mr. KROUT. Yes; I do.

Mr. PRATHER. I do, too.

Mr. JUDSON. Yes.

Senator MCINTYRE. I am curious about your assertion, Mr. Judson, Mr. Alerding, Mr. Prather, and Mr. Krout, about your assertion that S. 1900 guarantees that no institution will be subject to tax on income in excess of 100 percent of its taxable income.

Given the fact that each State may use whatever tax base it chooses, how can you guarantee that an institution which pays excise taxes in one State, income taxes in another State, franchise taxes in another State, will not end up paying more than 100 percent?

Mr. JUDSON. The guarantee is simply a guarantee that the tax base, whatever it is in a particular State, will be allocated as appropriate to tht State. If one State taxes on a different base, for example, gross receipts as compared to net income or capital stock, there could be a different net result, the tax would be greater than it would be in the home State, if only that State were taxing.

But the guarantee is solely that of fair division of the tax base, whatever tax base each State provides.

Mr. ALERDING. Mr. Judson and I both, interestingly enough, come from the two States which impose gross receipts taxes. Indiana and Washington. I think the gross receipts tax is a good example of the type of guarantee that this apportionment formula provides.

In Indiana, especially in banking, it is very easy for the State, under tested case law, to make a case that most of the receipts of the bank, if not all of them, do in fact derive from the State of Indiana.

This bill would provide relief for us, for instance, if Florida would have nexus under this bill and would tax a portion of our net income under its net income tax, because we would be provided some relief under the gross income tax in Indiana.

Absent this bill, we would not. So although I agree with you that a depository may pay more tax, because the base is not uniformly defined, there is in fact relief and equity accomplished by this bill.

Mr. PRATHER. I think the possibility of that happening is minimal. For one thing, at least in the savings and loan business, 37 States levy an income tax. So at least in 37 States it couldn't happen in the savings and loan case.

Mr. KROUT. I don't think there is any guarantee it won't happen. I think the provisions of the bill will certainly improve the situation tremendously, and it will be much less likely to happen than under the situation where each State imposes its own laws and is only restricted by constitutional limitations.

Senator MCINTYRE. Mr. Alerding, Mr. Krout, Mr. Prather, and Mr. Judson, it is my understanding, gentlemen, that the multi-State tax compact is an attempt to govern interstate taxaion of mercentile businesses generally. It is clear that this approach in your opinion is not satisfactory to government taxation of financial institutions and depositories. Would you please explain why not?

Mr. ALERDING. Senator, I think that there are a number of reasons. No. 1, I don't think the multistate compact has proven itself yet to the States. I think that it currently is in a state of disarray, and I think there is some discussion among the States. Several States have pulled out.

I believe Indiana most recently has left the multistate compact, and its last chairman happened to be the commissioner of our department of revenue.

So I think the States themselves again are unable to come up with clear agreement and uniformity, even in the multistate compact.

Even at its highest membership, I believe it represented no more than 21 or 22 States. That is a far cry from agreement among 50 States and the District of Columbia.

Senator McIntyre. Yes.

Mr. Prather. I believe the main fault with the compact is the fact it wasn't uniformly applicable throughout the country. In the few instances of savings and loan reciprocity laws for doing business in other States, the reciprocity has absolutely broken down after a few years' trial. One State will or will not go along with the other. It is a dangerous situation.

Mr. Krout. Mr. Chairman, I don't have any further information on the compact, but I would like to make this observation: I went to law school 35 years ago, and most of the cases we studied in constitutional law had to do with taxation of foreign corporations. I just read last week in the newspaper that the Supreme Court had decided a case involving taxation by Iowa. That is 35 years later.

It seems to me Congress has a great opportunity in the banking field, where all of this disparate type of taxation has not yet occurred, to draw ground rules right at the beginning which will perhaps prevent 35 years of litigation before people know what they can and can't do.

Senator McIntyre. We will take this in the regular order, Mr. Alerding, Mr. Judson, Mr. Prather, Mr. Krout.

Gentlemen, a subsequent witness from the State of California will testify that S. 1900 can only lead to the Federal Government dictating the policy by which States tax depositories. This, in turn, will allegedly lead to Federal control regarding taxation of all multi-State and multinational businesses.

It is alleged that such action is unwarranted, unnecessary, and a violation of State prerogatives. If a particular jurisdiction wishes to comply with the thrust of S. 1900, it should be allowed to, but not required to do so. How would you respond?

Mr. Alerding. Well, Senator, certainly in the absence of S. 1900, any of them can be allowed to comply right now. I don't think we would be here before Congress if we felt the States were able to come to some equitable solution on their own.

I think there is enough material—material abounds—to show that the States are totally incapable of coming to any agreement among themselves. I think it has been adequately pointed out that credit flows are different from other types of businesses, and we feel very strongly that there are Federal guidelines needed in this area.

I think the final thing is that if you trace banking, the banking and credit system in this country has always had Federal intervention, so to speak, if I can use that word, or Federal guidelines—all right, I won't use that word—Federal guidelines in many other areas.

It seems that the old saw of States rights always comes out when you hit the tax field. And yet there are many other cases regarding banking and many other things, where the Fede Government has seen fit

to impose guidelines. I think that this old saw just doesn't cut any more. I think it is time the Congress of the United States does intervene in the area of State taxation of depositories, but only for valid reasons. And I think we have pointed out those valid reasons.

My own personal opinion is they ought to intervene with nondepositories, too. But that is another question.

Mr. PRATHER. I don't believe it is intervention. Senator. I think what the Government is doing here is simply allocating a fair division among the States. It doesn't govern taxation, it does not dictate. As a matter of fact, the States have complete freedom in fixing their own tax formulas. So the statement does not jibe with the facts of this bill.

Mr. KROUT. I think on that point you must bear in mind the fact that mutual savings banks are long-term lenders. We make mortgage loans in these States, and the fact that the States might voluntarily comply with the spirit of S. 1900 one day doesn't mean they won't change the next year. That is exactly what happened in the case of Florida.

Senator MCINTYRE. Gentlemen, thank you very much for your testimony. I am sorry I cut down the last two witnesses, but we have another panel coming up. Thank you very much for your fine helpful testimony here this morning.

I will call as the next panel Daniel G. Smith, administrator, income sales, inheritance and excise taxes, Department of Revenue, Madison, Wis., and Benjamin F. Miller, legal staff, Franchise Tax Board, State of California. Mr. Owen L. Clarke, commissioner of corporations and taxation of the Commonwealth of Massachusetts hoped to be here, and was unable to come at the last moment.

So, Mr. Miller and Mr. Smith, we welcome you here this morning. You can testify in that order, Mr. Smith first, followed by Mr. Miller, and then we will have some questions for you. Your statements will appear in the record in their entirety.

STATEMENT OF DANIEL G. SMITH, ADMINISTRATOR, INCOME, SALES, INHERITANCE AND EXCISE TAXES, DEPARTMENT OF REVENUE, MADISON, WIS.

Mr. SMITH. My name is Daniel G. Smith, and I am tax administrator in the State of Wisconsin.

I think it would be appropriate, Senator, that before we discuss the particulars of S. 1900 or in general terms the provisions of any bill dealing with the interstate taxation of depositories, to review briefly for comparison purposes the Federal limitations now present on State taxation of other kinds of business functions.

As you have heard earlier today, Public Law 86–272 prohibits a State from imposing its income tax on a business selling tangible personal property if the only activity of that business is the solicitation of orders by a salesman or agent, which orders are sent outside of the State for approval and are filled from a point of delivery outside of that State.

This law, enacted in 1959, applies to proprietorships, partnerships, and corporations engaged in mercantile and manufacturing business activities. It does not, however, extend to those businesses which sell or provide services in more than one State.

With respect to sales and use taxes, there are several Supreme Court decisions which are guiding and provide the law and jurisdictional standards the States must follow in imposing those kind of taxes. It has been held that an out-of-State seller must collect a State's sales or use taxes if the business has a salesman or agent operating within the State whose only responsibility is the solicitation of customer orders. However, advertising in newspapers or on the radio with home delivery of merchandise by the seller's trucks, or solicitation of sales through catalogs with shipment of goods to customers via common carrier does not establish sufficient connection to require an out-of-State vendor to collect sales or use taxes for the State in which the customer resides.

In an interesting case decided recently by the Supreme Court, it involved a corporation doing business in the State of Washington. This company had one employee in the State of Washington. He did no selling. He was an engineer. He provided customer information or provided information to one customer that this company had in the State of Washington. He was a public relations person, representing that company in that State. In a 1975 decision of the Supreme Court, it held that these activities of that one employee sufficed to trigger Washington's business and occupation tax law, a gross receipts tax, on that out-of-State corporation.

Thus, for those selling tangible personal property, Federal law prescribes that an out-of-State business must have more than a salesman's presence in order for State income taxes to apply. For sales and use taxes, Federal guidelines permit more modest jurisdictional standards. A salesman or agent representing a vendor in a State establishes a sufficient connection which requires an out-of-State vendor to collect the State's sales or use taxes. As for a gross receipts tax, the Washington case has set a standard which allows jurisdiction to tax on the basis of a resident employee whose duties are to provide informational responses to a customer.

In each of these areas of taxation, Federal guidelines have established minimum, uncomplicated standards, which must be met or exceeded in order for the States to tax those businesses engaged in interstate commerce. It does not seem unreasonable then for the Congress to provide comparable criteria for State taxation of financial institutions electing to transact their business across State lines. However, in my view it is questionable if the precise jurisdictional standards, definitions of State tax base subject to apportionment, limitations on the joining together of affiliated depository corporations for tax measuring or the designation of a formula for the division of income between the States is warranted at this time.

Until very recently, 1969, States were prohibited from taxing the interstate business activities of national banks under R.S. 5219 and the moratorium provisions of the several laws that have been enacted since that time. National banks enjoyed a protected position, unlike that given any other business, for years. Under prior Federal law the States had few alternatives to choose from in taxing institutions. If they chose one tax, they had to forgo other levies. National banks, for example, were not taxed under the intangibles tax acts of the several States which imposed such levies, nor were they subject to documentary stamp taxes; they were immune from all States' use taxes and were

unaffected by sales tax laws which were construed to be a tax on the customer rather than on the seller.

It would seem unusual, I think, for the Congress to establish the standards provided in S. 1900 for the taxation of depositories, while ignoring other vitally important industries which are engaged heavily in interstate commerce.

To my knowledge, Congress has not demonstrated an interest in how the States tax the incomes of railroads, public utilities operating in two or more States, with the possible exception of a bill introduced by Senator Fannin in the last session of the Congress, pipelines, airlines, freight haulers, and bus companies. Many of these are regulated industries and there are no Federal guidelines with respect to the jurisdictional standards of the division base with respect to those kinds of businesses.

Because of tax restrictions of Federal law and the limitations placed on multi-State banking by Federal and State regulatory agencies, neither State tax officials nor representatives of the depository industry have experience in working with jurisdictional standards or in providing means for division of the tax base of a financial institution operating in several States. One gets the impression from the literature that the banking industry is in a very fluid State and that practices now existing will be changed in uncertain ways within the next decade. There is evidence of pressure for the removal of the traditional barriers to out-of-State activities by commercial banks and in certain instances by thrift institutions. Thus, it seems unwise to set into law all of the immutable measures now recommended in S. 1900.

With respect to specific comments on S. 1900, as you have heard before, the bill does provide a jurisdictional test which is based upon a business location. One example or one test which must be met is that a depository is deemed to have a business location in a State if it has one or more employees with a regular presence in such State. However, with almost "Catch 22" results, section 306(a) directs that an employee shall not be considered to be located or have a regular presence in a State if his activities within the State are the solicitation of loans, the receipt of deposits, which are subsequently transferred outside of the State, making credit investigations, real estate approvals, and so forth. While it seems that one section giveth, the other taketh away, with respect to this standard.

A business location is also established under the provisions of S. 1900 if a depository maintains an office in a State. Although an employee whose duties are restricted or excluded, and as we have just indicated, may be the sole purpose for the location of that office in the State, the presence of that office does constitute and does guarantee jurisdictional presence of the out-of-State depository in the taxing State.

If a depository regularly leases tangible property in a State, a business location is deemed to have been established. However, authority to tax in this situation is limited to the income with respect to such leased property. A number of banks provide, in my observation and experience, traditional nondepository services, in addition to leasing of tangible personal property, such as fiduciary, management, data processing operations and the like. If these undertakings are sufficiently within a State and there is an interdependence and a inter-

relationship between the separate departments of an existing depository, then the full scope of operations of the bank should be taken into account in dividing the tax base among the States.

This concept is not foreign to existing practices in the division of income between the States for all other kinds of businesses and to provide otherwise for banks and other depository institutions would create an unwarranted departure from existing uniformity in tax law administration.

Lastly, section 304 of the bill extends a business location to a depository which owns and uses tangible property involved in funds transfers in the State. It is predictable that electronic fund transfer devices, once permitted to operate across State lines, will be shared by several banks. It is not likely that the same corporation which owns these machines will also provide banking services. Thus, a remote bank, in competition with local financial institutions, may be allowed to accept deposits, make loans, and transfer amounts from one type of customer account to another without paying a State tax on such activities simply because it does not own the facility it uses.

With respect to the apportionment formula, section 201 of the bill provides a State may not impose a tax on the income or gross receipts by an amount which exceeds the application of the prescribed apportionment formula when multiplied by the State tax base.

The two equally weighted elements of this fraction are intended measures of a corporation's payroll and receipts factors for each taxing jurisdiction. It is my recommendation that Congress not extend its direction at this time in the matter of how income should be distributed among the States, other than to require that each jurisdiction observe a fairly apportioned standard. It may very well be the apportionment factor suggested in S. 1900 is an adequate and fair measure for the apportionment of incomes of depositories. However, again it is urged that experience in taxing multi-State banking activities be achieved before prescribing a precise formula.

With respect to the location of loan receipts, all interest, discount, net gain, and other receipts from each loan which is secured primarily by real estate is assigned to that State in which such security property is located provided a depository business location is established in that jurisdiction.

If the receipts from loans are attributable to property in a State which lacks taxing authority, however, the receipts are then assignable to the State in which the depository's principal office is located.

The apportionment of income of a depository doing business in two or more States should not employ a formula which includes a sales or receipts factor which attributes any part of the tax base to a taxing State on the basis of loans made to or owed by residents of that State or secured by property located in that State. The judgment of risks, the availability of investment funds, and the loan service functions of the depository occur at its principal offices. The location of the loan collateral is of secondary importance in determining where to place the loan receipts and the income from lending. Inclusion of this concept in any bill dealing with interstate taxation would lead to complexity, uncertain tax shifts, and uncompensated compliance burdens for taxpayers as well as the tax administrators.

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It is not clear to me what is intended by section 203(c)(3) with respect to the location of receipts from interest, dividends, and gains from securities. The bill provides that such amounts be attributed to the State, and I quote, "In which the principal trading activities are conducted." Does this mean that a bank in Wisconsin which is doing business in more than one State would be required to attribute its security and money market instrument income to the financial center States in which such activities regularly occur? If so, I would argue that this is an unreasoned allocation. Income gained from such activities is based upon decisions made by the officers and employees of the depository, who are located at the bank's headquarters. To attribute the results of those activities to a trading center is without justification.

With respect to exclusions, there are two items on which I would like to comment.

Dividends received from a corporation in which a depository owns at least 80 percent of the voting stock may not be included in taxable income. Wisconsin and other States, though not all, tax dividends received by its corporate taxpayers regardless of the relationship between the dividend paying and receiving entities. The section 205 exclusion for dividends carries over to this bill a Federal tax policy which allows a 100-percent dividends received deduction for qualifying dividends received by members of an affiliated group.

If enacted, this provision would modify State tax laws to an extent which could not have been contemplated. If one depository in my State qualified for taxation in more than one State, its dividend income from affiliated corporations would become excluded. Equal protection considerations would then certainly bring about similar treatment for other depositories and, ultimately, for all corporations. Certainly, the Congress does not intend its actions to impact so broadly on State tax policy by approving this provision. If an out-of-State bank is permitted and wishes to engage in business in Wisconsin, it must expect to be treated as are all other corporations. If it disapproves of our State's tax policy provisions, it is welcome to advance its recommendations for change to the legislature.

Section 205 lists another income item for exclusion from net income and gross receipts taxation. Income or receipts derived from the conduct of business at an office, branch, agency, or other fixed place of business located outside the United States is not taxable. Spokesmen for the depositories have indicated that an apportionment formula in an interstate taxation bill would not properly give appropriate weight to the differences in interest rates and wage levels for foreign operations. Nor, they continue, would any tax scheme reflect the different reserve and other regulatory requirements, money controls, exchange rate and currency fluctuations associated with foreign operations.

If bankers engaged in international finance cannot handle the arithmetic necessary to express their foreign branch office operations in stateside tax terms, I am at a loss to understand how they depict the income or loss from these overseas offices in their annual reports to shareholders. There is nothing sacrosanct about income from overseas or are the accounting problems of conversion to dollars that difficult. If a State wishes to allow separate accounting for a foreign operation, it will do so. However, the authority to include the results

of foreign transactions in net income subject to apportionment should not be denied.

Previously when the testimony was being taken and considerations were underway by the Advisory Commission on Intergovernmental Relations, I had the privilege to testify and represent my State's view with respect to what we think Congress should consider in the field of Federal legislation in dealing with the interstate taxation of depositories. On the last page of our testimony is a reprint of that recommendation, which we believe was good then and is good today.

Under this recommendation the State would deny authority to tax an out-of-State depository under a doing-business-type tax if the only activity or transaction conducted within the State was the solicitation of loans or deposits or sales of other depository services if these loans, deposits, or sales of service are approved or rejected, serviced, or performed at an office or other location outside the State. Authority to impose a tax would be denied if the only activities or transactions conducted within the State are the prosecution of remedies to enforce liens or otherwise protect a security interest in the case of a default on a loan.

In the interest of time, it is pretty much the same recommendation, with some slight change, that was made by the Advisory Commission. I think it creates a need for a substantial presence of a depository within a State before that State's taxes will be triggered.

I think if the Congress feels a compulsion to enact legislation to guide State taxation of interstate depositories, it may respectfully wish to consider this plan as an alternative to the provisions found in S. 1900. It is my final observation that the proponents of S. 1900 are unnecessarily concerned with what may happen, may happen, as time passes now that the moratorium on State imposition of doing business taxes has expired. The record to date, substantiated by a review of law changes by the National Association of Tax Administrators, does not uncover activities which support the fear that States will rush pellmell to adopt measures which will have deleterious consequences for banks and others.

You have heard testimony today about what may happen in Indiana, those banks that are bordering near Kentucky and Illinois, and Michigan. I cannot speak with certainty, but I would suggest that those bordering States have not made the first move to impose a tax on businesses, banking business so located.

What I believe has been chartered in S. 1900 is unnecessary in some instances and bad tax law in others. With respect to the argument that banks cannot with certainty engage in multistate activities without congressional insurance for safe passage, I would again ask that the record of the States in the past year or so be reviewed.

And, finally, I recall what was told me once, that the former chairman of the House Banking Committee on the occasion of the introduction of a draft such as this, cautioned and advised a younger member of the national legislature "If it's not broke, don't fix it." I think those words are impressive and important and significant today, when we consider S. 1900. I hope you will agree, Senator.

[The complete statement of Mr. Smith follows:]

TESTIMONY ON S. 1900,
by
Daniel G. Smith, Administrator
Income, Sales, Inheritance and Excise Taxes
State of Wisconsin

The purpose of my appearance before the Subcommittee on Financial Institutions is to describe, in a general way, the extent to which, I believe, the federal government should regulate state taxation of financial institutions and, more specifically, indicate which of the several provisions of S. 1900, identified as the Interstate Taxation of Depositories Act of 1977, require your cautious consideration.

FEDERAL LIMITATIONS IN OTHER TAX AREAS

Before discussing the taxation of depositories by states other than those in which they are domiciled or headquartered, it may be helpful to review -- for comparison purposes -- the federal limitations now present on state taxation of other kinds of business functions. Under P.L. 86-272, a state may not impose its income tax on a business selling tangible personal property if the only activity of that business is the solicitation of orders by a salesman or agent, which orders are sent outside the state for approval, and are filled by delivery from a point outside the state. This law, enacted in 1959, applies to proprietorships, partnerships, and corporations engaged in mercantile and manufacturing business activities. It does not, however, extend to those businesses which sell or provide services in more than one state.

In three cases, the U.S. Supreme Court has provided jurisdictional guidelines for the imposition of state sales and use taxes.[1] It has been held that an out-of-state seller must collect a state's sales or use taxes if the business has a salesman or agent operating within the state whose only responsibility is the solicitation of customer orders. However advertising in newspapers or on the radio with home delivery of merchandise by the seller's trucks, or solicitation of sales through catalogues with shipment of goods to customers via common carrier does not establish sufficient connection to require an out-of-state vendor to collect sales or use taxes for the state in which the customer resides.

A Pennsylvania corporation had one employe in the State of Washington. He did no selling. Operating out of an office in his home, he devoted most of his time to maintaining good company relations with one customer. Sometimes, he gathered and transmitted product requirement data to his employer. In a 1975 decision, the U.S. Supreme Court held that these activities of one employe sufficed to trigger Washington's business and occupation tax levy on the out-of-state corporation.[2]

Thus, for those selling tangible personal property, federal law prescribes that an out-of-state business must have more than a salesman's presence in order for state income taxes to apply. For sales and use taxes, federal guidelines permit more modest jurisdictional standards. A salesman or agent representing a vendor establishes a sufficient connection which requires the out-of-state vendor to collect the state's sales or use taxes. As for a gross receipts tax, the Washington case has set a standard which allows jurisdiction to tax on the basis of a resident employe whose duties are to provide informational responses to a customer.

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[1] Miller Bros. v. Maryland, 347 U.S. 340 (1954); Scripto, Inc. v. Carson, 362 U.S. 207 (1960); and National Bellas Hess v. Illinois Dept. of Revenue, 386 U.S. 753 (1967)

[2] Standard Pressed Steel Co. v. Washington Dept. of Revenue, Docket No. 73-1697, Jan. 22, 1975

In each of these areas of taxation, federal guidelines have established minimum, uncompromised standards which must be met or exceeded in order for the states to tax these businesses engaged in interstate commerce. It does not seem unreasonable then for the Congress to provide comparable criteria for state taxation of financial institutions electing to transact their business across state lines. However, it is questionable if precise jurisdictional standards, definitions of state tax base subject to apportionment, limitations on the joining together of affiliated depository corporations for tax measuring or the designation of a formula for the division of income between the states is warranted at this time.

PRIOR AND PRESENT LIMITATIONS

Until recently, states were prohibited from taxing the interstate business activities of national banks under R.S. 5219 and the moratorium provisions of P.L. 91-156, as subsequently extended under P.L. 93-100. National banks enjoyed a protected position, unlike that given any other business for many years. Under prior federal law, the states had few alternatives to choose from in taxing these institutions. If they chose one tax, they had to forego all other levies. National banks not taxed under the intangibles tax acts of several states imposing such levies; they were not subject to documentary stamp taxes they were immune from all states' use taxes and were unaffected by sales tax laws which construed to be a tax on the customer, rather than on the seller. The moratorium which restricted state imposition of 'doing business' taxes on depositories expired in September, 1976.

OTHER BUSINESSES

It would seem unusual for the Congress to establish the standards provided in S. 1900 for the taxation of depositories while ignoring other vitally important industries which are engaged heavily in interstate commerce. To my knowledge, Congress has not demonstrated an interest in how the states tax the incomes of railroads, public utilities operating in two or more states, pipelines, airlines, freight haulers or bus companies. While claims made that S. 1900 similar legislation is necessary to insure the free flow of commerce through an efficient banking system, these other service industries, equally essential to our economic well-being, do not seem to be impeded by lack of federal guidelines.

EXPERIENCE IN INTERSTATE TAXATION

Because of the tax restricitions of federal law and the limitations placed on multistate banking by federal and state regulatory agencies, neither state tax officials nor representatives of the depository industry have experience in working with jurisdictional standards or in providing for ivision of the tax base of a financial institution operating in several states. One gets the impression that the banking industry is in a very fluid state and that practices now existing will be changed in uncertain ways withi the next decade. There is evidence of pressure for the removal of the traditional barriers to out-of-state activities by commercial banks, and, in certain instances, by thrift institutions. Thus, it seems unwise to set into law all of the immutable measures now recommended in S. 1900.

SPECIFIC COMMENTS ON S. 1900

JURISDICTIONAL STANDARD (BUSINESS LOCATION)

The bill provides that a business location test must be applied before a state shall have the power to impose its doing business tax on a depository. Sec. 101. There are four business location standards prescribed in Sec. 304. Each of these, however, is qualified in other sections of the bill in sometimes curious, sometimes undesirable ways. For example, a depository is deemed to have a business location in a state if it has one or more employes with a regular presence in such state. However, Sec. 306(a) directs that an employe shall not be considered to be located or have a regular presence in a state if his activities within the state are the solicitation of loans, the receipt of deposits which are subsequently transferred outside the state, making credit investigations and real estate appraisals, acting as trustee of a profit-sharing or retirement plan, enforcing loan collection by judicial processes, etc. What one section seems to giveth, another then taketh away.

A business location also is established if a depository maintains an office in a state. Although an employe whose duties are restricted to "the solicitation of applications for loans which are sent outside the state for approval, . . ." when located in such office does not establish a taxable connection, according to Sec. 306, the presence of an office which exists solely to provide the employe with a place to work gives the state authority to tax. Once established, under Sec. 316, the power to tax will then permit the attribution of certain loan receipts to that state if loan applicati received for approval in the office -- by that very same "excepted" employe even though the approval process is completed elsewhere.

If a depository regularly leases tangible personal property in a state, a business location is deemed to have been established. However, authority to tax this situation is limited to income with respect to such leased property. number of banks provide traditional non-depository services -- in addition to leasing tangible personal property such fiduciary, management, data processing operations, and the like. If these undertakings are sufficiently within a state and there is an interdependence and interrelationship between the separate departments of a depository, then the full scope of operations of the bank should be taken into account in dividing the tax base among the states. This concept is not foreign to existing practices in the division of income between the states for all other kinds of businesses, and to provide otherwise -- for banks only woul create an unwarranted departure from existing uniformity tax law administration.

And lastly, Sec. 304 extends a business location to a depository which owns and uses tangible property involved in funds transfers in the state. It is predictable that electronic fund transfer devices, once permitted to operate across state lines, will be shared by several banks. It is not likely that the same corporation which owns these machines will also provide banking services. Thus, a remote bank, in competition with local financial institutions, may be allowed to accept deposits, make loans and transfer amounts from one type of customer account to another without paying a state tax on such activities simply because it does not own the facility it uses.

APPORTIONMENT FORMULA

Sec. 201 of the bill specifies that a state may not impose a tax on the income or gross receipts of a depository doing business in more than one state beyond an amount which results from multiplying the net income or gross receipts, by prescribed apportionment fraction. The two equally weighted elements of this fraction are intended measures of a corporation's payroll and receipts factors for each taxing jurisdiction. It is my recommendation that Congress not extend its direction, at this time, in the matter of how income should be distributed among the states other than to require that each jurisdiction observe a "fairly apportioned" standard. It may very well be that the apportionment factor suggested in S. 1900 is an adequate and fair measure for the apportionment of income of depositories operating across state lines. Again, it is argued, that experience in the taxing multistate banking activities be achieved before prescribing a precise formula.

LOCATION OF LOAN RECEIPTS

All interest, discount, net gain and other receipts from each loan which is secured primarily by real estate is assigned to that state in which such security property is located provided a depository business location is established in that jurisdiction. Sec. 203(b). If the receipts from loans are attributable to property in state which lacks taxing authority, however, the receipts are then assignable to the state in which the depository's principal office is located.

The apportionment of income of depository doing business in two or more states should not employ a formula which includes a sales or receipts factor which attributes any part of the tax base to a taxing state on the basis of loans made to or owed by residents of that state or secured by property located in that state. The judgment of risks, the availability of investment funds and the loan service functions of the depository occur at its principal offices. The location of the loan collateral is of secondary importance in determining where to place the loan receipts and the income from lending. Inclusion of this concept in any bill dealing with interstate taxation would lead to complexity, uncertain tax shifts and uncompensated compliance burdens for taxpayers as wel as the tax administrators

It is not clear what is intended by Sec. 203(c)(3) with respect to the location of receipts from interest, dividends and gains from securities. The bill provides that such amounts be attributed to the state "in which the principal trading activities are conducted". Does this mean that bank Wisconsin which doing business in more than one state would be required to attribute its security and money market instrument income to the financial center states in which such activities regularly occur? If so, I would argue that this is an unreasoned allocation. Income gained from such activities is based upon decisions made by the officers and employes of a depository located at the bank's headquarters. To attribute the results of those activities to a trading center is without justification.

EXCLUSIONS

Dividends received from a corporation in which a depository owns at least 80 percent of the voting stock may not be included in taxable income. Wisconsin and other states tax dividends received by its corporate taxpayers regardless of the relationship between the dividend paying and receiving entities. The Sec. 205 exclusion for dividends carries over to this bill a federal tax policy which allows 100 percent dividends received deduction for qualifying dividends received by members of an affiliated group.

If enacted, this provision would modify state tax laws to an extent which could not have been contemplated. If one depository in my state qualified for taxation in more than one state, its dividend income from affiliated corporations would become excluded. Equal protection considerations would then certainly bring about similar treatment for other depositories and, ultimately, for all corporations. Certainly, the Congress does not intend its actions to impact broadly state tax policy by approving this provision. If an out-of-state bank is permitted and wishes to engage in business in Wisconsin, it must expect to be treated as are all other corporations. If it disapproves of our state's tax policy provisions, it is welcomed to advance its recommendations for change to the legislature.

Sec. 205 lists another income item for exclusion from net income and gross receipts taxation. Income (or receipts) derived from the conduct of business at an office, branch, agency other fixed place of business located outside the United States is not taxable. Spokesmen for the depositories have indicated that an apportionment formula in an interstate taxation bil would not properly give appropriate weight to the differences in interest rates and wage levels for foreign operations. Nor, they continue, would any tax scheme reflect the different reserve and other regulatory requirements, money controls, exchange rate and currency fluctuations associated with foreign operations.

If bankers engaged in international finance cannot handle the arithmetic necessary to express their foreign branch office operations in stateside tax terms, I'm at a loss to understand how they depict the income or loss from these overseas offices in their annual reports to shareholders. There's nothing sacrosanct about income from overseas nor are the accounting problems of conversion to dollars that difficult. If a state wishes to allow separate accounting for a foreign operation, it will do so. However, the authority to include the results of foreign transactions in net income subject to apportionment should not be denied.

AN ALTERNATIVE RECOMMENDATION

On a previous occasion, I presented Wisconsin's recommendations for federal legislation with respect to state doing business taxes of insured depositories.[1] That proposal, appearing at the end of this written testimony, represents the continued position of my state.

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[1]Hearings of the Advisory Commission on Intergovernmental Relations, Washington, April 10, 1975.

Under this recommendation, a state would be denied authority to tax an out-of-state depository under a doing business type tax if the only activity or transaction conducted within the state was the solicitation of loans or deposits or sales of other depository services if these loans, deposits, sales of services are approved or rejected, serviced, or performed at an office or other location outside the state. Authority to impose a tax would be denied if the only activities or transactions conducted within the state are the prosecution of remedies to enforce liens or otherwise protect a security interest in the case of a default on a loan.

Rather than prescribe definite apportionment factors, whenever apportionment of the income tax base on an out-of-state depository is required, the tax may be applied only on a fairly apportioned part of the depository's net income, receipts, etc. Additionally, in any case dealing with the apportionment of income of a depository doing business in two or more states, the formula should not include a sales or receipts factor to be used in such a way as to attribute any part of the tax base to a taxing state on the basis of loans made to or owed by residents of that state or secured by property located in that state, or on the basis of deposits received or held for persons resident or domiciled in that state.

While this outline for federal legislation may not satisfy those athirst for precise direction in all situations which will occur, it does establish criteria under which depositories knowingly may plan for expanded operations and by which state administrators may determine the tax consequences of those activities. It does not place artificial limits on the taxation of income according to its type, nor does it direct an allocation of receipts in untraditional ways. This plan preserves existing state tax bases, prescribes a jurisdictional standard which assigns income to the states in a familiar way and requires that the apportionment of a financial institution's income must be equitable.

If the Congress feels a compulsion to enact legislation to guide the states' taxation of interstate depositories, it may wish to consider this plan as an alternative to S. 1900.

STATE ACTION SINCE END OF MORATORIUM

My final observation that the proponents of S. 1900 are unnecessarily concerned with what may happen as time passes that the moratorium on state imposition of doing business taxes has expired. The record to date, substantiated by a review of law changes by the National Association of Tax Administrators does not uncover activities which support the fear that states will rush pell-mell to adopt measures which will have deleterious consequences for banks and others.

What has been charted in S. 1900 is unnecessary in some instances and bad tax law in others. With respect to the argument that banks cannot with certainty engage in multi-state activities without congressional insurance for safe passage, I would again ask that the record of the states in the past year or more be reviewed. It is reported that the late Representative Wright Patman, for many years chairman of the House Banking Committee, said, "If it's not broke, don't fix it", at the time of introduction of legislation intended to cure problems yet to develop. I think those few words have significance for us today in considering S. 1900. I hope the committee agrees.

RECOMMENDATION FOR LEGISLATION ON STATE DOING BUSINESS TAXES OF DEPOSITORIES

(a) It is recommended that the Congress enact legislation which would deny authority for any state or local government to impose on an out-of-state commercial bank, mutual savings bank, savings and loan association, or credit union

(1) a tax on or measured by income, or by other receipts from banking or depository services or by property (except tangible personal property located in the state) or

(2) any other tax including a franchise, privilege, general excise, or license tax on or with respect to the conduct of the business of banking or providing other depository services in the state

if during any taxable year or other period the only business activities or transactions conducted within the state by or on behalf of such entity are (1) the solicitation of loans (whether or not secured by property located in the state), or deposits, or sales of other depository services, and these loans, deposits or sales of depository services are approved or rejected, or made or received, or serviced or performed at an office or other location outside the state or (2) the prosecution of remedies to enforce liens or otherwise protect a security interest in case of default on a loan or other indebtedness secured by property located in the state.

(b) Further, such legislation should provide that

(1) where a state, in conformity with the foregoing limitations, establishes jurisdiction to impose a tax on or measured by the income, receipts or property of a depository institution that has its home office or principal place of business in another state, the tax may be applied only on a fairly apportioned part of the depository's entire net income, receipts, property or other tax base and

(2) for purposes of such fair apportionment the apportionment formula shall not include a sales or other factor so defined that it attributes any part of the tax base to the taxing state on the basis of loans made to or owed by residents of that state or secured by property located in that state or on the basis of deposits received or held for persons resident or domiciled in that state, unless such loans or deposits are approved, or made, or received at an office or other location within the state.

Senator McINTYRE. Thank you, Mr. Smith. Mr. Miller.

STATEMENT OF BENJAMIN F. MILLER, LEGAL STAFF, FRANCHISE TAX BOARD, STATE OF CALIFORNIA

Mr. MILLER. Mr. Chairman, contrary to the statements of the gentleman who testified before, I think I am to a large extent in accord with Mr. Smith's testimony, and I think this demonstrates the States can in fact come to some agreement.

[The statement of Mr. Miller and attachments follow:]

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
SACRAMENTO, CALIFORNIA 95807
TELEPHONE: (916) 355-0892

November 16, 1977

The Honorable Thomas J. McIntyre, U.S.S.
Chairman
Subcommittee on Financial Institution
Committee on Banking, Housing, and Urban Affairs
Washington, D.C. 20510

Thank you for your invitation to testify and offer comments on the "Interstate Taxation of Depositories Act of 1977." The California Franchise Tax Board welcomes the opportunity to make known its views on this proposed legislation and any other legislation effecting the state's rights and methods of taxation.

In 1860 Congress enacted legislation which waived the immunity of national banks from state taxation to the extent of authorizing the states to impose real property taxes on national banks and nondiscriminatory personal property taxes on national bank shares or on the capital stock of national banks. In 1860 this was for all practical purposes a complete waiver of the immunity of national banks from state taxation. Over the passage of years, the methods by which states could tax national banks were gradually expanded, but these methods were not expanded as quickly as the methods by which states taxed general corporations. What was originally intended to be a complete waiver of immunity from state and local taxation with respect to national banks became instead a protective barrier for such banks.

In 1969 legislation was enacted directing the Federal Reserve Board to make a study of state and local taxation and to report to Congress its recommendations as to what, if any, further federal legislation may be needed to reconcile the promotion of the economic efficiency of the banking systems, with the achievement of effectiveness and local economy in meeting the fiscal needs of the states and their political subdivisions. The Federal Reserve report was submitted at the end of 1971. Apparently dissatisfied with the Federal Reserve's report, Congress, in August, 1973, directed the Advisory Commission on Inter-Governmental Relations to make a new study and prepare a report.

Its recommendations were submitted to Congress in May of 1975. The recommendations of the ACIR were fairly limited and dealt mainly with the enactment of a jurisdictional standards test similar to those applicable to general mercantile corporations as set forth in Public Law 86-272. Hearings were held on the ACIR report in May of 1976 The California Franchise Tax Board submitted a written statement and also presented oral testimony at those hearings

It was the position of the California Franchise Tax Board in those hearings that there was no need for federal involvement in state or local taxation of multi-state and multi-national businesses, whether they be depositories, banks, financial or general corporations. It is still our position that no federal involvement is warranted. We are opposed to Senate Bill 1900.

The states have been free to tax national banks or depositories in whatever manner they might choose for only a very limited period of time. As far as we are aware there have been no significant changes in the manner in which national banks or depositories are taxed by state and local governments. Until such time as specific, real problems are identified we see no basis for enacting legislation such as Senate Bill 1900 which would reinstate preferential treatment for depositories having operations in more than one state or one country There has been no showing made that such treatment is needed or required and we believe it would be particularly inappropriate given the recent elimination of preferential treatment.

California's method for taxing national banks and depositories has been carefully developed over a long period of time Under California law tate and national banks and other financial corporations have always been taxed in the same manner. Financial corporations are taxed at a higher rate than general corporations because national banks have been exempted from certain taxes applicable to other corporations. This additional income tax burden has been specifically designed to equalize the tax burden on banks, financial corporations and general corporations. The California method for taxing national banks was judicially approved in Security First National Bank v. Franchise Tax Board, 55 Cal.2d 407, Appeal dismissed 363 U.S. 3.

California utilizes a three factor apportionment formula to compute the California portion of the income of a unitary bank or depository business. This formula has been specifically designed to be intergrated with the Uniform Division of Income for Tax Purposes Act (UDITPA) by which California and a number of other states tax general business corporations. A comprehensive guideline has been adopted and published which is applicable to all financials This guideline was developed in consultation with the Californi Bankers Association and some of its member banks. A copy of this guideline is attached.

California's guideline for the apportionment of income of banks and financial corporations has been submitted to the Multi-State Tax Commission (MTC) for its consideration and we are hopeful that after appropriate review and revision it will become a standard method used by all MTC states and perhaps by others. We believe this shows that the states are able to develop appropriate methods for taxing national banks and depositories without federal assistance.

If federal legislation is to be adopted dealing with state and local methods of taxing national banks, it should be limited to a jurisdictional standard similar to that set forth for general corporations in Public Law 86-272, as recommended by the ACIR report. If more extensive federal legislation is enacted the guideline developed by California may be useful.

While we are filing for the record our concern as to specific provisions of the bill, we wish to make two observations with respect to the bill. First, in our view it is completely inappropriate to tax in-state depositories in one manner and to tax out-of-state depositories in a different manner. Under the formula method of computing taxable income, the activities of in-state and out-of-state corporations should be reflected in an identical manner If a particular jurisdiction wishes to waive its right to tax particular activities in order to encourage such activities by out-of-state institutions it should be allowed, but not required, to do so.

Attached to our written statement is a copy of Section 191(d) of the California Corporation Code which specifies a number of activities which an out-of-state financial institution can engage in California without being subject to tax. These specific exceptions have been enacted by the State of California to encourage out-of-state financial corporations to conduct business in California. We believe that it should be up to each individual state to determine what activities of out-of-state financials it wishes to specifically encourage within its own jurisdiction. This should not be mandated by federal legislation.

Second, enactment of Senate Bill 1900 can lead to but one result the dictation by the Federal Government of state policies for the taxation of depositories. No facts have been submitted which justify such radical intervention in state taxes Such comprehensive legislation would inevitably lead to federal control as to the taxation of all multi-state and multi-national businesses. Such action is unwarranted and unnecessary.

Mr. Benjamin F. Miller, Counsel for the Franchise Tax Board will appear and make a brief statement at the November 22, 1977 hearing.

Martin Huff
Executive Officer

Attachments

Comments on Specific Provisions of S. 1900
"Interstate Taxation of Depositories Act of 1977"

As in the proposed "Interstate Taxation of Depositories Act of 1976" this bill continues to incorporate the most objectionable features of various bills prepared by business associations which have been developed to exempt large amounts of income of multistate and multinational business and permits tax consequences to be governed by the corporate form through which the business is conducted rather than such consequences being governed by substance. The assumption is that restrictive federal interstate tax legislation will be provided for other businesses and depositories are entitled to parity. We believe the assumption is invalid. Aside from the requirement that national banks be taxed similar to state banks, the only restrictive federal legislation materially affecting state taxes is Public Law 86-272. We are not convinced that massive restrictive legislation should be enacted in the absence of a clear demonstration that the state taxing methods are unreasonable or inequitable. We believe that an objective review of state taxing methods, and in particular as relating to depositories, would establish that they are taxed fairly and equitably.

Sec. 101 This section generally restates existing law. The activities of any affiliate of a depository engaged in a common business should be sufficient to establish jurisdiction to tax and the section should be amended to so provide.

Sec. 201(a) The bill proposes that a two-factor formula (payroll and receipts) be utilized to establish a ceiling on the amount of tax which may be assessed a depository taxable in more than one state.

California utilizes a three factor formula (property, including tangibles, payroll and receipts) for apportioning the income of depositories or other similar businesses which is founded on the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). We believe this approach is fairer to all depositories, large and small, and thus is preferable to the two factor formula for several reasons. First, it taxes depositories and other financials in a manner similar to that used for all other corporations. Second, the use of a three factor formula has been recognized and approved by the states and courts for a number of years. Third, this formula encompasses the three principal activities which generate income, that is, the investment of capital, the efforts of labor, and

access to the market place. These three elements are equally as productive and important for a depository or financial as they are for other corporations. Fourth, it will discriminate against other financials who compete with such depositories and use the standard three factor formula. Fifth, it will attribute less income to the home office state since investments are typically larger in such states. Finally, the absence of a property factor in any formula apportionment applicable to capital or capital stock taxes is illogical.

Sec. 201 (b) This is the test adopted under UDITPA for general corporations and it is appropriate also for depositories or financials.

Sec. 201(c)(1) Neither the states nor the taxpayers should be able to require combination in all cases. Affiliated corporations in unrelated business should not be combined for example. Some area of discretion for variances should be allowed both the states and taxpayers similar to Sec. 18 of UDITPA.

We see no reason that Edge Act corporations should be excluded from a combination if their business activities are a part of the general business of the affiliated group. Further comments with respect to the definition of an affiliated group and unitary business are set forth under Sec. 310.

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Sec. 201(c)(2) There is no basis for distinguishing between depositories which have their principal office in the taxing state as compared to those which have their office located outside of the state. Once a depository meets the jurisdictional standard there should be no distinction made as to how its income is computed. This section could cause either more than or less than 100% of a depositories income being subject to tax since a depository might file a return or pay tax on one tax base in its home state and a different tax base in other states.

In addition there is no basis for excluding the income and factors of the entities solely on the basis of the characteristics listed in subsections (A), (B) and (C). Reliance solely on these tests will allow a taxpayer to manipulate its form of conducting business to its best advantage. Under the unitary concept utilizing both combined reporting and formulary accounting it is only if all the activities of the related corporations are taken into account that the true income of any element, or derived from any jurisdiction, may be determined. General corporations have to account for all such income and activities and are taxed on this basis and there is no reason depositories should be treated differently.

(FTB 11/77)

Sec. 202 This is in accord with general UDITPA principles. See "Guideline for Apportionment of Income of Banks and Financial Corporations." Attachment.

Sec. 203 For greater specificity and slightly different rules see "Guideline for Apportionment of Income of Banks and Financial Corporations." Attachment. These rules were worked out in consultation with industry representatives and we believe that they reach a fair and equitable result and urge that they be adopted in place of the language in the bill.

Under subsection (d) significant receipts will be excluded from the factor. The guideline developed by California includes virtually all of the receipts received by financial and is therefore preferable.

Sec. 204 No comment.

Sec. 205(a)(1) Dividends received from a corporation which are not included within the business carried on by the depository and are not includable in the combined return set forth in Section 201(c), as modified by our statement, need not be excluded from income. Also, there is no sound reason for an artificial 80% ownership test since control is present when stock is owned in excess of 50%.

Sec. 205(a)(2) This exclusion should be struck. Under formula accounting as utilized in California the true income realized and taxable from any source can be determined only after including all the activities and income of a business wherever located and apportioning such income on the basis of a formula. There is no other acceptable method to determine the income realized outside of the United States. Any separate accounting method is susceptible to manipulation, intentional or not, because of the subjective judgments which must be made by the taxpayer in assigning receipts and expenses. This provision goes beyond the recommendation of the ACIR.

Sec. 205(b) No comment.

Sec. 301 No comment.

Sec. 302 There should be no distinction made between depositories and other nondepository financial entities which are in competition with them. Providing a method of taxation applicable solely to depositories might result in different and discriminatory tax treatment between such entities and other financials.

There is an inconsistency between the elimination of so-called foreign source income and the inclusion of foreign companies in the definition of depositories. This could lead to discriminatory taxation of local depositories as compared to foreign owned depositories.

Sec. 303 — The term "State" should include the Commonwealth of Puerto Rico, any territory or possession of the United States and any foreign country.

Sec. 304(a) — Subsections (i) and (ii) are similar to the standards applied to general corporations under Public Law 86-272. Subsection (iii) is acceptable only in part. Once jurisdiction is established no limitation should be placed on the income or activities to be taxed as is apparently required by the last paragraph of this section. Subsection (iv) should be revised to eliminate the requirement of ownership. Use alone should be sufficient since much of the equipment involved in "funds transfers" is of a character which is typically only leased or rented.

Sec. 304(b) — The definition of "independent contractor" is not acceptable. Under the definitions set forth an independent contractor could include a nondepository corporation more than 50% owned by the depository or affiliated entity and which acts for an unrelated

principle in one isolated incident a year while acting primarily for the depository.

The activities of separate corporate entities included in the affiliated group should establish jurisdiction to tax with respect to all members of the group if they are engaged in one business.

Sec. 304(b)(3) could result in none of several nonaffiliated depositories making loans or participating in loans within a state being taxable. Each would act as a shield for the other.

Questions exist as to the necessity of any of these restrictions. California Corporations Code § 191(d), copy attached, already establishes somewhat similar restrictions for California purposes. We believe the establishment of such restrictions or waiver of taxable jurisdiction should be left to each individual state so the individual needs of each state can be met. As long as a state must recognize the taxable nexus of another state over income realized by a depository there is no danger of multiple taxation. Certainly no restrictions greater than those set forth in California Corporations Code § 191(d) should be enacted.

Sec. 304(b)(5) is unacceptable since such property is normally leased or rented and the extent of the income producing activity is not diminished by lack of ownership.

Sec. 304(c) No comment.

Sec. 305(a) No comment.

Sec. 305(b) An apportioned base between jurisdictions for property which is used in several jurisdictions should be utilized rather than assigning such property to only one jurisdiction.

Sec. 305(c) No comment.

Sec. 306(a) An apportionment of an employee's salary between states could be utilized if his activities are sufficient to create nexus in each state rather than assigning all of an employees salary to one state similar to Sec. 305(b).

Sec. 306(b) Comments made with respect to Sec. 304(b) are applicable in addition subsection (1) may be inconsistent with Sec. 316 since all that is required for Sec. 316 is the presence of an employee with the authorization to approve a loan whether or not such authorization is exercised.

This section discriminates against purely local depositories in favor of larger multi-state entities.

Sec. 307-309 No comment.

Sec. 310 The 80% test is arbitrary and artificial and is derived from the federal consolidated return test and has no relevance to the unitary business concept as practiced by California and other states and should be eliminated. The standard unitary tests enunciated in Butler Bros. v. McColgan 315 US 801 (1941) and Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472, 183 P.2d 16 (1947) should be used. Under California authorities and general unitary theory ownership in excess of 50% is sufficient provided the activities of the affiliated corporations constitute one business. Under this test related corporations involved in different businesses would not be combined. Otherwise the theory of combined reporting set forth in 201(c)(1) is subverted.

Sec. 311 No comment.

Sec. 312 This section should be struck. This is the "waters edge" concept contained in the Internal Revenue Code and is inconsistent with unitary theory as practiced by California and other states. Consideration is currently being given by other committees

of Congress (Senate Foreign Relations Committee, House Committee on Ways & Means) as to whether or not the results of foreign activities should be reflected in the combined report of general corporations. Any decision on this bill should be reserved pending their determination. Depositories or financials should be treated no differently than other corporations.

Sec. 313-15 No comment.

Sec. 316 No Comment.

Sec. 351-352 No comment.

For Div. 1, eff. until Jan. 1, 1977, see Div. 1, ante and main volume

§ 190. Surviving corporation

"Surviving corporation" means a corporation into which one or more other corporations are merged.

(Added by Stats.1975, c. 682, p. —, § 7, eff. Jan. 1, 1977.)

§ 191. Transact intrastate business; foreign corporation

(a) For the purposes of Chapter 21 (commencing with Section 2100), "transact intrastate business" means entering into repeated and successive transactions of its business in this state, other than interstate or foreign commerce.

(b) A foreign corporation shall not be considered to be transacting intrastate business merely because its subsidiary transacts intrastate business.

(c) Without excluding other activities which may not constitute transacting intrastate business, a foreign corporation shall not be considered to be transacting intrastate business within the meaning of subdivision (a) solely by reason of carrying on in this state any one or more of the following activities:

(1) Maintaining or defending any action or suit or any administrative or arbitration proceeding, or effecting the settlement thereof or the settlement of claims or disputes.

(2) Holding meetings of its board or shareholders or carrying on other activities concerning its internal affairs.

(3) Maintaining bank accounts.

(4) Maintaining offices or agencies for the transfer, exchange and registration of its securities or depositaries with relation to its securities.

(5) Effecting sales through independent contractors.

(6) Soliciting or procuring orders, whether by mail or through employees or agents or otherwise, where such orders require acceptance without this state before becoming binding contracts.

(7) Creating evidences of debt or mortgages, liens or security interests on real or personal property.

(8) Conducting an isolated transaction completed within a period of 180 days and not in the course of a number of repeated transactions of like nature.

(d) Without excluding other activities which may not constitute transacting intrastate business, any foreign lending institution, including, but not limited to: any foreign banking corporation, any foreign corporation * * * all of the capital stock of which is owned by one or more foreign banking corporations, any foreign savings and loan association, any foreign insurance company or any foreign corporation or association authorized by its charter to invest in loans secured by real and personal property, whether organized under the laws of the United States or of any other state, district or territory of the United States, shall not be considered to be doing, transacting * * * or engaging in business * * * in this state solely by reason of engaging in any * * * or * * * all of the following activities * * * either on its own behalf or as a trustee of a pension plan, employee profit sharing or retirement plan, testamentary or inter vivos trust, or in any other fiduciary capacity:

(1) The acquisition by purchase, by contract to purchase, by making of advance commitments to purchase or by assignment of loans, secured or unsecured, or any interest therein, if such activities are carried on from outside this state by the lending institution.

(2) The making by an officer or employee of physical inspections and appraisals of real or personal property securing or proposed to secure any loan, if the officer or employee making any physical inspection or appraisal is not a resident of and does not maintain a place of business for such purpose in this state.

Asterisks * * * indicate deletions by amendment

(3) The ownership of any loans and the enforcement of any loans by trustee's sale, judicial process or deed in lieu of foreclosure or otherwise.

(4) The modification, renewal, extension, transfer or sale of loans or the acceptance of additional or substitute security therefor or the full or partial release of the security therefor or the acceptance of substitute or additional obligors thereon, if the activities are carried on from outside this state by the lending institution.

(5) The engaging by contractual arrangement of a corporation, firm or association, qualified to do business in this state, which is not a subsidiary or parent of the lending institution and which is not under common management with the lending institution, to make collections and to service loans in any manner whatsoever, including the payment of ground rents, taxes, assessments, insurance and the like and the making, on behalf of the lending institution, of physical inspections and appraisals of real or personal property securing any loans or proposed to secure any loans, and the performance of any such engagement.

(6) The acquisition of title to the real or personal property covered by any mortgage, deed of trust or other security instrument by trustee's sale, judicial sale, foreclosure or deed in lieu of foreclosure, or for the purpose of transferring title to any federal agency or instrumentality as the insurer or guarantor of any loan, and the retention of title to any real or personal property so acquired pending the orderly sale or other disposition thereof.

(7) The engaging in activities necessary or appropriate to carry out any of the foregoing activities.

Nothing contained in this subdivision * * * shall be construed to permit any foreign banking corporation to maintain an office in this state otherwise than as provided by the laws of this state or to limit the powers conferred upon any foreign banking corporation as set forth in the laws of this state or to permit any foreign lending institution to maintain an office in this state except as otherwise permitted under the laws of this state.

(Added by Stats.1975, c. 682, p. —, § 7, eff. Jan. 1, 1977. Amended by Stats.1976, c. 641, p. —, § 4.9, eff. Jan. 1, 1977.)

1976 Amendment. Rewrote the introductory paragraph of subd. (d) previously had read: "(d) Any foreign corporation engaged in the business of making or investing in loans shall not be considered to be transacting intrastate business within the meaning of subdivision (a) by reason of engaging in any one or more of the following activities in addition to those specified in subdivision(c);" and in the last paragraph it referred to "this subdivision" instead of "this subdivision (d)."

Library References
Corporations ⊂=642.
C.J.S. Corporations § 1928 et seq.
Words and Phrases (Perm.Ed.)

§ 192. Vacancy

"Vacancy" when used with respect to the board means any authorized position of director which is not then filled by a duly elected * * * director, whether caused by death, resignation, removal, change in the authorized number of directors (by the board or the shareholders) or otherwise.

(Added by Stats.1975, c. 682, p. —, § 7, eff. Jan. 1, 1977. Amended by Stats.1976, c. 641, p. —, § 5, eff. Jan. 1, 1977.)

1976 Amendment. Deleted "and acting" following "duly elected."

Library References
Words and Phrases (Perm.Ed.)

§ 193. Verified

"Verified" means that the statements contained in a certificate or other document are declared to be true of the own knowledge of the persons executing the same in either:

(a) An affidavit signed by them under oath before an officer authorized by the laws of this state or of the place where it is executed to administer oaths, or

(b) A declaration in writing executed by them under "penalty of perjury" and stating the date and place (whether within or without this state) of execution.

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
SACRAMENTO, CALIFORNIA 95857

Guideline for Apportionment of Income of Banks and Financial Corporations

I. Introduction

Banks and financial corporations conducting business activities within and without this state are required to determine and report business income derived from sources within this state as provided in the Uniform Division of Income for Tax Purposes Act (UDITPA), Sections 25120-25139, inclusive, Revenue and Taxation Code. The general regulations for UDITPA, Regs. 25120-25139, inclusive, are applicable except as otherwise provided in this guideline. The three-factor apportionment formula of property, payroll and sales provided in UDITPA and certain rules set forth in the regulations have been modified in order to provide an equitable apportionment of income.

All income of banks and financial corporations is ordinarily "business income" within the meaning of Section 25120(a), Revenue and Taxation Code.

The apportionment formula prescribed herein shall be applicable to income years beginning after December 31, 1975.

II. Definitions

A. The following definitions shall apply in the construction of this guideline:

1. The term "original cost" for property factor purposes is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. If the original cost of property is unascertainable, the property is included in the property factor at its fair market value as of the date of acquisition by the taxpayer (Reg. 25130(a)).

2. "Receipts" for sales factor purposes means gross income including net taxable gain on disposition of assets derived from transactions and activities in the regular course of the taxpayer's trade or business which produce business income.

3. Participation loans are joint loans by more than one bank to a common borrower.

4. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with the taxpayer's business so that substantial use or value attaches to the property.

III. Apportionment Formula

A. Property Factor

1. In general —

(a) The property factor includes all owned real and personal property, both tangible and intangible, and rented real and tangible personal property used in the business.

(b) Owned real property and tangible personal property is to be included at original cost.

(c) Owned intangible personal property is to be included at its tax basis for federal income tax purposes Goodwill shall not be included in the property factor.

(d) Rental property is valued at eight times the net annual rental rate.

(e) Coin and currency is to be taken into account for property factor purposes.

2. The denominator of the property factor includes:

(a) Real and tangible personal property owned or rented and used in the business.

(b) Intangible personal property owned and used in the business.

3. The numerator of the property factor includes the following:

(a) Real and tangible personal property owned or rented and used in the business in this state.

(b) Coin and currency located in this state.

(c) Intangible personal property owned and used in the business determined as follows:

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(i) Assets in the nature of loans (including federal funds sold and banker's acceptances) and installment obligations shall be attributed to the state where the office of the bank or financial corporation is located at which the customer applied for the loan except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located. For purposes of this paragraph the word "applied" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first in time.

(ii) A participating bank's portion of a participation loan shall be attributed to the state where the office of the participating bank is located which entered into such loan.

(iii) Loans initiated through solicitation by traveling loan officers shall be attributed to the state where the office out of which he operates is located except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located.

(iv) Bank credit card and travel and entertainment credit card receivables shall be attributed to the state in which the credit card holder resides in the case of an individual or, if a corporation, to the state of the corporation's commercial domicile, provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state of the individual card holders residence or commercial domicile of the corporate card holder, such receivables shall be attributed to the state of the taxpayer's commercial domicile.

(v) Investments of a bank in securities, the income from which constitutes business income, shall be attributed to its commercial domicile except that:

(I) Securities used to maintain reserves against deposits to meet federal and state reserve deposit requirements shall be attributed to each state based upon the ratio that total deposits in the state bear to total deposits everywhere.

(II) Securities owned by a bank but held by a state treasurer or other public official or pledged to secure public or trust funds deposited in such bank shall be attributed to the banking office at which such secured deposit is maintained.

(vi) Investments of a financial corporation in securities, the income from which constitutes business income, shall be attributed to its commercial domicile unless the securities have acquired a business situs elsewhere.

(d) Where the taxpayer leases tangible personal property to another the entire cost of such property shall be attributed to the state of the taxpayer's commercial domicile unless the taxpayer establishes, or the Franchise Tax Board requires, that all or a portion of the cost of such property should be attributed to a different state or allocated between more than one state. (See Reg. 25122 when taxpayer is taxable in another state.)

B. Payroll Factor

1. Compensation paid during the tax period shall be included in the numerator and denominator as provided in Sections 25132 and 25133, Revenue and Taxation Code, and the regulations thereunder.

C. Sales Factor

1. Most receipts derived from transactions and activities in the regular course of the trade or business which produce business income are included in the denominator of the sales factor (see Sections 25134-25137, inclusive, and the regulations thereunder).

2. The numerator of the sales factor is that portion of the total receipts included in the denominator of the taxpayer attributable to this state during the income year.

3. Receipts from the sale, lease, rental or other use of real property shall be included in the numerator as provided in Section 25136 and the regulations thereunder.

4. Receipts from the sale or use of tangible personal property, other than lease or rental receipts, shall be included in the numerator as provided in Sections 25134 to 25137, inclusive, and the regulations thereunder. Receipts from the lease or rental of tangible personal property shall be attributed to the state of the taxpayer's commercial domicile unless the taxpayer establishes, or the Franchise Tax Board requires, that all or a portion of such receipts should be attributed to a different state or allocated between more than one state.

5. Receipts from intangible personal property shall be included in the numerator as follows:

   (a) Interest and other receipts from assets in the nature of loans (including federal funds sold and banker's acceptances) and installment obligations shall be attributed to the state where the office is located at which the customer applied for the loan except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located. For purposes of this paragraph the word "applied" means initial inquiry (including customer assistance in preparing the loan application0 or submission of a completed loan application, whichever occurs first in time.

   (b) Interest income from a participating bank's portion of participation loan shall be attributed to the state where the office of the participating bank is located which entered into such loan.

(c) Interest income from loans solicited by traveling loan officers shall be attributed to the state where the office out of which he operates is located except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located.

(d) Interest or service charges from bank, travel and entertainment credit card receivables and credit card holders fees shall be attributed to the state in which the credit card holder resides in the case of an individual or if a corporation, to the state of the corporation's commercial domicile, provided the taxpayer is taxable in such state f the taxpayer is not taxable in the state of the individual card holder's residence or commercial domicile of the corporate card holder the receipts shall be attributed to the state of the taxpayer's commercial domicile.

(e) Merchant discount income derived from bank and financial corporation credit card holder transactions with a merchant shall be attributed to the state in which the merchant is located provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state in which the merchant is located, the merchant discount income shall be attributed to the state in which the taxpayer's commercial domicile is located.

(f) Receipts for the performance of fiduciary services are attributable to the state where the services are principally performed.

(g) Receipts from investments of a bank in securities, the income from which constitutes business income, shall be attributed to its commercial domicile except that:

(i) receipts from securities used to maintain reserves against deposits to meet federal and state reserve deposit requirements shall be attributed to each state based upon the ratio that total deposits in the state bear to total deposits everywhere.

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(ii) receipts from securities owned by a bank but held by a state treasurer or other public official or pledged to secure public or trust funds deposited in such bank shall be attributed to the banking office at which such secured deposit is maintained.

(h) Receipts (fees or charges) from the issuance of travelers checks and money orders shall be attributed to the state where the taxpayer's office is located that issued the travelers checks. If the travelers checks are issued by an independent representative or agent of the taxpayer, the following rules apply:

(i) If the taxpayer is taxable in the state in which the independent representative or agent issues the travelers checks or money orders, the receipts (fees or charges) shall be attributed to that state.

(ii) If the taxpayer is not taxable in the state in which the independent representative or agent issues the travelers checks or money orders, the receipts (fees or charges) shall be attributed to the state of commercial domicile of the taxpayer

(i) Receipts from investments of a financial corporation, the income from which constitutes business income, shall be attributed to its commercial domicile unless the securities have acquired a business situs elsewhere.

Senator McIntyre. Here we were, all of the bankers came in and they are all in unity for once in my lifetime, and then you gentlemen come in and smudge it all up.

I am going to ask some questions. We will start with Mr. Smith on the first question, and you can comment, add to, disagree, Mr. Miller. The next question will be to you, Mr. Miller, and we will go back and forth that way.

Now, Mr. Smith, in general is it fair to assume that the positions of the individual States on this issue reflect their individual assessments as to whether Federal legislation or the absence of Federal legislation will result in maximum revenue to the State?

In other words, aren't the positions of various States really dollars and cents positions?

Mr. Smith. Oh, I don't think so, Senator. I don't think that is an adequate characterization of what the States are thinking.

I will admit that there are differences among the States with respect to what provisions of any interstate taxation bill should be. Some of the testimony that you heard earlier this morning, I think, is a fair characterization, that those States which happen to be the money market States have different views with respect to the change in the tax situation, with respect to the depositories than do, say, the other States which are not money market centers.

Although both here is Congress and back home we are characterized as money grabbers and our own interests are maximizing revenue for our respective jurisdictions, I think we approach our decisions a little more rationally than that.

Senator McIntyre. Mr. Miller? The question is, isn't your position really a dollars and cents position; fundamentally that is what you fellows are really worried about?

Mr. Miller. We don't think that is the case. Certainly that is an element which must be considered by the State tax administrators. But it has certainly been California's experience over the years that as soon as you take a dollars and cents position, not a principled or a well-reasoned position, you may collect more money over the short run, for a year or two, but that businesses will find ways to circumvent your rules and you wind up having your rule used against you. It just doesn't work.

The only way to establish your rules is to try to reach what you feel is the fairest and most equitable method of determining the tax. Set up a system that will operate uniformly with respect to all taxpayers and apply it uniformly.

I think over the years California has a good record of making those efforts.

So, yes, in the short run you look at the dollars and cents. But that is a very shortsighted view. I think the experienced of Florida and some other States may demonstrate the consequences of such a short-sighted view.

Senator McIntyre. Mr. Miller and Mr. Smith, your positions are very well stated in your testimony. I am curious, however. The Advisory Commission on Intergovernmental Relations endorsed the concept of negative guidelines, whereby there should be certain restrictions on the State's ability to tax, but that the States should not be required to standardize their tax policies

Does this bill, in an attempt to standardize national treatment of taxation of out-of-State depositories, also impose substantive restrictions on the ability of States to tax their own domestic banks?

Mr. MILLER. Yes; it does to the extent that local banks can bring up an equal protection argument. If you have a bank which is operating, a depository operating, solely within the State, the bill would have no effect upon it. But you will wind up with political arguments or political solutions to discrimination in favor of out-of-State banks proposed to the legislature by the local banks which will result in legislation which will in effect put the taxation of one-State depositories on the same basis as multistate depositories.

Senator MCINTYRE. Do you agree?

Mr. SMITH. Yes.

Senator MCINTYRE. Mr. Smith, Mr. Miller, it has been suggested that the tax treatment for banks contained in this bill represents in effect preferential treatment and to this extent depositories are given a competitive advantage not available to other kinds of nondepository competitors.

This is particularly true in States which use other than a two-factor formula. How would you respond to this assertion?

Mr. SMITH. I probably am the worst one to ask, because our State does use a two-factor formula.

Under the exclusions from the tax base if enacted, the depository institutions would not be required to include in their base certain elements of income which are now there by State statute.

As I said in the testimony, I don't think any State can maintain that position for very long, because of equal protection issues.

Senator MCINTYRE. Mr. Miller?

Mr. MILLER. Yes; I think there is an element of preferential treatment in this bill, at least from California's point of view. The tax base is defined differently in that foreign-source income is excluded.

There is a question with respect to interstate depositories as compared to local depositories, in what California calls a combined return. A return including the activities of the individual depository, and its subsidiaries or related corporations is defined in one manner for a corporation which does business within and without the State, and is defined in a different manner for one which does business solely within California. I think that is discrimination.

There certainly has to be a difference in the formula which is applied to the banking industry as compared to that which is applied to a general mercantile corporation. As we have endeavored to do, our guidelines, we have attempted to follow the general provisions of UDITPA and have tried to adapt those to the requirements of the banking industry and of the depositories. This guideline was developed in conjunction with the industry. It does recognize that the industry is different. You do have to use different measuring devices to fairly apportion income. But we have tried to make it as similar as possible to the way we tax general mercantile corporations. There is no doubt there is a difference, and some different treatment must be used. But we don't think any preferential treatment is required.

Senator MCINTYRE. We noted, Mr. Miller, that you testified that the apportionment formula contained in this bill is unreasonable. I would

like Mr. Miller to comment on that. Is the two-factor approach contained in S. 1960 unreasonable?

Mr. SMITH. Our experience—I am not trying to hedge, Senator our experience with the two-factor formula in Wisconsin has been applied to small loan companies. To my knowledge, we have not required the apportionment of income of any depositories under the State tax laws in Wisconsin. So based upon that experience, I think it has led to reasonable results and reasonable division of the tax load between the States in which these kinds of financial institutions are operating.

We have no eperience with respect to the apportionment of income of banks, so I really am without expertise on that.

Senator MCINTYRE. You don't know whether it is unreasonable or not then?

Mr. SMITH. It is a guess.

Senator MCINTYRE. Well, guess.

Mr. SMITH. I think it would be reasonable.

Mr. MILLER. If I might comment, Senator, perhaps unreasonable would be too strong a term. California, prior to 1967, when we adopted the UDITPA provisions, did in fact use the two factor formula for financials. We have now gone to a three-factor formula which we believe is more reasonable than the two-factor approach.

Mr. SMITH. In the division of any income the reason we have to do this is because businesses cannot separately account for the jurisdictions. I am relating now to the mercantile and manufacturing businesses. That is why we go to the approximation formula. It is an approximation. So you very carefully select the elements that make up that formula and ask do they reasonably measure the income earning activities of the business which is making income across State lines.

It is our feeling in Wisconsin, that banks make money by the activities of their personnel, and by their sales or receipts from loans. And that property in the traditional sense has little effect on that income-earning capacity. That is why we feel that in our State the two-factor formula is reasonable.

Mr. MILLER. We certainly found that to be the case with respect to tangible property for financials. That is why we have included intangible property as well. The intangibles we feel are very similar to what a tangible property investment would be for the general mercantile companies. Intangibles are the assets banks use to generate income. That is why we believe it should be reflected in the factors.

But as to the choice between two or three factors, we think the three is much better than the two. But either one represents an approximation.

We did a very quick revenue estimate as to what the effect of the use of a two factor versus a three factor would be, and it was maybe $10 million difference. There was a slight shift in the apportionment factor, according to our survey. Basically, a property factor, of whatever kind, would in general favor the State of domicile, since typically most of the property is located there. So generally if you look at a bank within a particular State, if you use a three-factor approach, the home State will get a slightly greater percentage of income of that corporation taxable to itself than would be allocated outside the State.

Senator McIntyre. Mr. Smith and Mr. Miller, what has been the activity of the various States to date—although the moratorium has been expired for quite some time now, I am not aware that any States are currently taxing any out-of-State financial depositories. What is the reasonable expectation, if this or other Federal legislation were not enacted, what is the reasonable expectation of this sort of activity by the States?

Mr. Smith. That is very difficult to answer, Senator. There has been activity, it has been referred to many times here, in the State of Florida. I have not talked to the tax commissioner in the State of Florida to know what either he or his State legislature has in mind with respect to the future taxation of out-of-State depositories.

Based on personal conversations that I have had with tax administrators in other States, there doesn't seem to be any substantial interest in changing the methods which the States have adopted in the past.

There is one State that I know of that has changed its tax law. It has curious and uncertain consequences, and to be frank, I don't know what the results are. The State of South Dakota had a law dealing with jurisdictional standards. It recently passed a new law which abrogated those standards. I don't know what the consequences of that action will be.

Mr. Miller. Mr. Chairman, we are unaware of any significant effort by any State to make a change. I don't foresee any change on California's part. The only change that might occur, and I don't think we are that far away from it, would be to insure that we are taxing national banks, depositories, in basically the same manner we tax general corporations, so there will be no distinction between depositories and general corporations.

We have a provision in our constitution which would prohibit us from taxing out-of-State depsitories, and also the Federal provision prohibiting taxing out-of-State depositories, in any manner or form to a greater extent than we do our own in-State financials.

Senator McIntyre. Mr. Miller, Mr. Smith, much has been said about the impact of tax barriers on impeding the free flow of credit. Is this a real concern? Or isn't it reasonable to assume financial institutions, like other businesses, will engage in profitable activities whenever and wherever they may be located, and accept the tax consequences?

Wouldn't banks follow where profits lead them? Are these so-called tax barriers a real concern?

Mr. Miller. I don't think they are, no. I think you have stated it correctly, the banks will go where profits are. Certainly taxes will be a consideration in their decisions. To the extent a State feels that it is at a disadvantage, they can enact specific provisions creating a more favorable business climate within the State.

It has also been our experience that corporations will utilize the corporate form to come up with devices to circumvent most tax laws anyway. We believe the provisions of S. 1900, several of the provisions, which would exhort the form of business over its substance, the incorporation of individual or specific subsidiary corporations to perform a particular function within a State, could have a significant impact on the tax consequences. That we don't think is correct.

Mr. SMITH. I agree. I would like to add this: We have a long area in which we are most familiar [illegible] State level. Most of the State tax rates [illegible] modest compared to the Federal tax rate. [illegible] tax rate is 7.5 percent on net income. I think [illegible] ballpark with respect to other State tax [illegible] decides to institute a substantial [illegible] on impose its tax, and we have various [illegible] decision will be made, as for all businesses, [illegible] to invade that market, and about [illegible] should be made. For you what [illegible]

Mr. MILLER. I think the [illegible] That is, why should the rules [illegible] to any preferential treatment [illegible] general corporations are not [illegible] that has been set forth [illegible] ferently from general [illegible]

Senator MCINTYRE. Mr. [illegible] ing that the multi-State tax [illegible] taxation of mercantile businesses [illegible] relationship should there be [illegible] and the taxation of depositories?

Mr. SMITH. I would like to defer [illegible] has not been or is anticipated [illegible] California is.

Senator MCINTYRE. All right, Mr. [illegible]

Mr. MILLER. As we have [illegible] our guideline for financials [illegible] review, we think it is an appropriate [illegible] gether and to adopt standard treatments [illegible] for the taxation of any businesses. We have already, in connection with the MTC, adopted a number of guidelines, or several guidelines with respect to individual industries, and the method of computing their tax. We think the financials are another area where this can be done and we have submitted our guidelines to the MTC. At such point in time as the MTC takes it up, and determines that modifications should be made from the California approach, I would anticipate California would change their formula to confrom with whatever final recommendation the MTC comes to.

So, yes, we strongly urge this as an appropriate vehicle. Give us a little time to get the MTC working and get all the States together on it and it will be effective.

Senator MCINTYRE. Mr. Smith, this is the last question, just for you. It has been urged that any necessary uniform rules could be adopted by concerted action of the States. Based upon your lengthy experience as a tax administrator and as president of the National Association of Tax Administrators, do you have any basis for anticipating such voluntary concerted action in light of the failure of the States to so act to develop rules for nondepository businesses?

Mr. SMITH. Probably the best one could hope for is through the vehicle of the National Association of Tax Administrators, which represents all the States, by way of resolution and with the effect resolutions of an agency such as that have upon the participating

members, that is to establish and recommend guidelines for the States to follow. We would not anticipate much more than that, however.

Senator McIntyre. Lest I forget, without objection, the cover letter from Mr. Huff, the executive officer of the Franchise Tax Board, together with the accompanying guideline statements which you presented, Mr. Miller, will appear in the record in conjunction or right after your statement.

I want to thank both of you for your constructive criticisms and for the appearance here today. It is very helpful to us.

Now, we know we have a contest on our hands. I thought this morning we were running wild before the wind.

Thank you very much, gentlemen.

[Thereupon, at 12:20 p.m. the hearing was adjourned.]

[Additional material received for the record follows in the appendix:]

APPENDIX

95TH CONGRESS
1ST SESSION

S. 1900

IN THE SENATE OF THE UNITED STATES

JULY 20 (legislative day, JULY [illegible]), 1977

Mr. McINTYRE (by request) introduced the following bill which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

A BILL

To clarify the treatment of banks and other depository institutions under State and local revenue laws.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act be cited as the "Interstate Taxation of Depositories Act of 1977".

TITLE I—JURISDICTION TO TAX

SEC. 101. UNIFORM JURISDICTIONAL STANDARD: BUSINESS LOCATION TEST.

No State or political subdivision thereof shall have power to impose a doing-business tax on a depository unless such depository has a business location in the State or political subdivision during the taxable year.

TITLE II—MAXIMUM PERCENTAGE OF INCOME, RECEIPTS, OR CAPITAL ATTRIBUTABLE TO TAXING JURISDICTION

SEC. 201. OPTIONAL TWO-FACTOR FORMULA.

(a) A State or political subdivision thereof may not impose for any taxable year on a depository taxable in more than one State a doing-business tax measured by an amount of net income, gross receipts, or capital in excess of the amount determined by multiplying the depository's base by an apportionment fraction, the numerator of which is the sum of the payroll factor and the receipts factor and the denominator of which is 2. For this purpose the base to which the apportionment fraction is applied shall be such depository's net income, gross receipts, or capital for that taxable year as determined under State law, with the exceptions provided for in section 205.

(b) TAXABLE IN MORE THAN ONE STATE; TAXABLE IN A STATE.—For purposes of this title, a depository is taxable in more than one State if, pursuant to title I, more than one State has jurisdiction to impose a doing-business tax upon the depository regardless of whether, in fact, any State does or does not impose such a tax.

For purposes of this title, a depository is taxable in a State if, pursuant to title I, that State has jurisdiction to impose a doing-business tax upon the depository regardless

of whether, in fact, that State does or does not impose such a tax.

(c) COMBINED REPORTING.—

(1) Except as provided in subparagraph (2), a participant State may require, or a depository may elect, that its net income, grross receipts, or capital be determined by reference to the combined base and apportionment factors of all corporations of an affiliated group of which the depository is a member, except a corporation organized under section 25(a) of the Federal Reserve Act having its principal office located outside the State.

(2) A State may not require a depository not having its principal office in the State, nor may such depository elect, to combine or consolidate for the purpose of determining its net income, gross receipts, or capital with the net income, gross receipts, or capital of the following:

(A) A corporation which is not a depository as defined under this Act,

(B) A corporation which is incorporated outside of the United States, or

(C) Any corporation which derives more than 90 percent of its income from sources without the United States.

SEC. 202. PAYROLL FACTOR.

(a) IN GENERAL.—The payroll factor is a fraction, the numerator of which is the total amount paid in the State by the depository as compensation and the denominator of which is the total amount paid in all States by the depository as compensation during the taxable year.

(b) LOCATION OF COMPENSATION.—Compensation is paid in a participant State if paid to an employee considered to be located or as having a regular presence therein, as provided in section 306. All compensation paid by a depository to an employee located in a State in which the depository is not taxable shall be deemed to have been paid in the State in which the depository has its principal office.

SEC. 203. RECEIPTS FACTOR.

(a) IN GENERAL.—The receipts factor is a fraction, the numerator of which is the receipts of the depository which are located in the State during the taxable year and the denominator of which is the total receipts of the depository within the United States during such taxable year.

(b) LOCATION OF RECEIPTS FROM LOANS.—All interest, discount, net gain and other receipts from each loan which is secured primarily by real estate, shall be included in the numerator of a participant State if the predominant part of such security property is or will be located in such State,

as determined in accordance with section 305; and the interest, discount, and net gain from each unsecured loan and each loan secured primarily by tangible or intangible personal property, or any participating interest therein, shall be included in the numerator of a participant State if such loan was originated in such State. All interest, discount, net gain and other receipts from loans which are located in a State in which the depository is not taxable shall be included in the numerator of the State in which the depository's principal office is located.

(c) LOCATION OF CERTAIN OTHER RECEIPTS.—

(1) Fees, commissions, service charges, and other receipts from the sale of depository or financial services shall be included in the numerator of the State in which the service is performed. Sales or services rendered in two or more States shall for purposes of the numerator be included in the numerator of the State in which the greater portion of the income-producing activity is performed, based on costs of performance.

(2) Receipts from the lease of tangible property shall be considered to be located in the State in which the property is located.

(3) Interest, dividends, and net gains from securities (whether held for investment or trading purposes)

and money market instruments are included in the numerator of the State in which the principal trading activities are conducted.

(d) ALL OTHER RECEIPTS.—All receipts other than those described in subsections (b) and (c) of this section shall be excluded from both the numerator and the denominator of the receipts factor for all participant States.

SEC. 204. LOCAL TAXES.

The maximum net income, gross receipts, or capital attributable to a participant political subdivision for tax purposes shall be determined under this title in the same manner as though such political subdivision were a State; except that the denominators of the depository's payroll factor and receipts factor shall be the denominators applicable to all States and political subdivisions. For this purpose, the numerators of the depository's payroll factor shall be determined by treating each reference to a participant State as a reference to a participant political subdivision.

SEC. 205. EXCLUSIONS FROM NET INCOME, GROSS RECEIPTS, AND CAPITAL.

(a) EXCLUSIONS FROM NET INCOME AND GROSS RECEIPTS.—The net income or gross receipts of a depository shall not include (1) dividends received from a corporation in which such depository owns at least 80 percent of the voting stock or (2) net income or gross receipts which are

derived from the conduct of business at an office, branch, agency or other fixed place of business located outside the United States.

(b) EXCLUSIONS FROM CAPITAL.—The capital of a depository shall not include investments in, and advancements to, affiliated corporations.

TITLE III—DEFINITIONS AND MISCELLANEOUS PROVISIONS

PART A—DEFINITIONS

SEC. 301. DOING BUSINESS TAX.

The term "doing business tax" means any tax imposed on, or measured by, net income; any tax which is imposed upon or measured by gross income or gross receipts; or any tax imposed for the franchise, privilege, excise, or license for the doing of business of banking in the State or providing other lending or depository services based on the value of property, assets, or capital employed in the State.

SEC. 302. DEPOSITORY.

The term "depository" means any bank the deposits of which are insured under the Federal Deposit Insurance Act, any institution the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, or any thrift or home financing institution which is a member of a Federal home loan bank; any other bank or thrift institution incorporated or organized under the laws of any State which is

engaged in the business of receiving deposits; or any company organized or created under the laws of a foreign country which maintains or owns a branch or subsidiary in the United States which receives deposits.

SEC. 303. STATE.

The term "State" means any of the several States of the United States and the District of Columbia.

SEC. 304. BUSINESS LOCATION.

(a) GENERAL RULE.—A depository shall be deemed to have a "business location" in a State in a taxable year only if (i) such depository maintains an office in such State; (ii) one or more employees of the depository has or have a regular presence in such State; (iii) such depository regularly leases to others tangible personal property located in such State; or (iv) such depository owns and uses tangible property involved in funds transfers in the State.

If a depository has a business location in a State solely by reason of (iii), such depository shall be considered to have a business location in that State only with respect to such leased property.

(b) APPLICATION OF GENERAL RULE.—For purposes of subsection (a), a depository shall not be deemed to have a business location within a State during any taxable year merely by reason of (1) the acquisition or purchase of loans, secured and unsecured, or any interest therein, from

one or more independent contractors having a business location in the State: (2) the maintenance of an office in the State by, or the business activities in the State of, one or more independent contractors, including but not limited to the collecting and servicing of loans to any manner whatsoever and the making, on behalf of such depository, of physical inspection and appraisals of real or personal property in such State securing any loans or proposed to secure any loan; (3) making loans through or in participation with other depositories having offices in the State; (4) holding, sale, assignment, transfer, collecting or enforcing any loans, or the foreclosure or other disposition thereof, including acquisition of title to property securing such loans by foreclosure, deed in lieu of foreclosure, or otherwise, as a result of default under the terms of the mortgage or other security instruments relating thereto, or holding, protection, rental, maintenance and operation of said property so acquired or the disposition thereof; provided, that such depository shall pay real estate taxes on said property, and shall not hold, own or operate said property for a period exceeding 5 years from the final date of its acquisition; or (5) by reason of the use of tangible property involved in funds transfers owned by independent contractors.

The term "independent contractor," as used in reference to a particular depository, means any individual, corporation,

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partnership, voluntary association, trust, or other entity, other than such depository engaged in business activities on behalf of more than one principal, including such depository, but such term shall not include any employee of such depository.

(c) POLITICAL SUBDIVISION.—For the purpose of determining whether a depository has a business location in a political subdivision, subsection (a) shall be applied by treating each reference therein to a State as reference to a political subdivision.

SEC. 305. LOCATION OF PROPERTY.

(a) GENERAL RULE.—Except as otherwise provided in this section, tangible property, including real property which is security for a loan, shall be considered to be located in the State in which such property is physically situated.

(b) MOVING PROPERTY LEASED TO OTHERS.—Tangible personal property which is characteristically moving property, such as motor vehicles, rolling stock, aircraft, vessels, mobile equipment, and the like, and which is leased to others for use, shall be considered to be located in the State if—

(1) the operation of the property by the lessee is entirely within that State, or the operation without the State is occasional or incidental to its operation within the State; or

(2) the operation of the [redacted] in two or more States and the principal use of operations from which the [redacted] is in that State.

(c) POLITICAL SUBDIVISIONS.—For the purposes of determining whether property is located in a political subdivision, subsections (a) and (b) shall be applied by treating each reference therein to a State as a reference to a political subdivision.

SEC. 306. LOCATION OF EMPLOYEE.

(a) IN GENERAL.—An employee shall be considered to be located in a State or political subdivision thereof if—

(1) the employee's service is performed entirely within the State;

(2) the employee's service is performed both within and without the State, but the service performed without the State is incidental to the employee's service within the State; or

(3) some of the employee's service is performed in the State; and

(A) the base of operations, or if there is no base of operations, the place from which the employee's service is directed or controlled is within the State; or

(B) the base of operations or the place from which the service is directed or controlled is not within any State in which some part of the service is performed but the employee's residence is within the State.

(b) EXCEPTED ACTIVITIES.—An employee shall not be considered to be located or to have a regular presence in a State if his or her only business activities within such State on behalf of his or her employer are any of the following:

(1) The solicitation of applications for loans which are sent outside the State for approval, of deposits which are received and maintained at an office outside the State, and of financial or depository services which are performed outside the State;

(2) The making of credit investigations and of physical inspections and appraisals of real and personal property securing or proposed to secure any loan;

(3) The filing of a security interest; the enforcement of any loans by trustee sale, the judicial process or deed in lieu of foreclosure; or the maintaining or defending of any action or suit; and

(4) Acting as an executor of an estate, trustee of a benefit plan, employee's profit-sharing or retirement plan, testamentary or intervivos trust, corporate indenture, or in any other fiduciary capacity, including but

not limited to holding a title to real property in the State. This subsection shall not apply with respect to the business activities carried on by one or more employees within a State if the employer (without regard to those employees) has a business location in such State.

(c) POLITICAL SUBDIVISION.—For the purpose of determining whether an employee is located or has a regular presence in a political subdivision, subsections (a) and (b) shall be applied by treating each reference therein to a State as a reference to a political subdivision.

SEC. 307. COMPENSATION.

"Compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services.

SEC. 308. SECURITIES.

The term "securities" means United States Treasury securities, obligations of United States Government agencies and corporations, obligations of State and political subdivisions, corporate stock and other securities (excluding stock of corporations the dividends of which are excluded from net income or gross receipts), and participations in securities backed by mortgages held by United States or State government agencies.

SEC. 309. MONEY MARKET INSTRUMENTS.

The term "money market instruments" means Federal funds sold and securities purc[illegible] agreements to re-

sell, commercial paper, purchased banker's acceptances, and purchased certificates of deposit.

SEC. 310. AFFILIATED CORPORATIONS.

Two or more corporations shall be deemed to be members of an "affiliated group" comprised of one or more corporate members if they are connected through stock ownership with a common owner, which may be either corporate or noncorporate, in the following manner:

(a) 80 percent or more of the voting stock of each member other than the common owner is owned directly by one or more of the other members; and

(b) 80 percent or more of the voting stock of at least one of the members other than the common owner is owned directly by the common owner.

SEC. 311. EMPLOYEE.

The term "employee" has the same meaning as it has for purposes of Federal income tax withholding under chapter 25 of the Internal Revenue Code of 1954, as amended.

SEC. 312. INCOME FROM SOURCES WITHOUT THE UNITED STATES.

"Income from sources without the United States" means income from sources without the United States as defined by the Internal Revenue Code of 1954, as amended.

SEC. 313. TANGIBLE PROPERTY INVOLVED IN FUNDS TRANSFERS.

The term "tangible property involved in funds trans-

fers" shall include, but not by way of limitation, automated teller machines, point of sale terminals, clearing house facilities, wire systems and other electronic or electronic credit authorization and direct payment systems.

SEC. 314. PARTICIPANT STATE.

The term "participant State" means a State in which a depository has a business location during a particular taxable year.

SEC. 315. PARTICIPANT POLITICAL SUBDIVISION.

The term "participant political subdivision" means a political subdivision in which a depository has a business location during a particular taxable year.

SEC. 316. ORIGINATION OF LOANS.

A loan shall be deemed to have been originated in the State if the loan application, including any application for prearranged extension of credit, is received for approval at an office within the State or by an employee within the State who has a regular presence therein and who is authorized to approve such loans.

PART B—MISCELLANEOUS PROVISIONS

SEC. 351. PROHIBITION AGAINST DISCRIMINATION.

No State or political subdivision may impose a doing business tax on any depository not having its principal office within such State which would not be imposed, or at a higher rate than would be, if such depository had its principal office in the State.

SEC. 352. APPLICABILITY OF ACT.

Nothing in this Act shall be considered—

(a) to repeal section 548 of title 12, United States Code, or section 1464(h) of title 12, United States Code; or

(b) to prevent a State or political subdivision from enacting legislation that would result in a lesser tax liability than provided in the Act.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

November 18, 1977

Dear Mr. Chairman:

This responds to your request for our comments on S. 1900, the Interstate Taxation of Depositories Act of 1977.

Title I of the bill would prohibit a state or any of its political subdivisions from imposing a doing business tax on a depository unless such depository has a business location in the state or political subdivision during the taxable year. Title II would establish an optional two-factor formula which a state may use to calculate the applicable state tax base of a depository taxable in two or more states.

Title III provides definitions for key terms used in the bill. Of particular note are the following:

-- "doing business tax" is defined as any tax measured by net income or imposed for the franchise, privilege or license of conducting business within the borders of a state. This tax also could be based upon the value of property, assets or capital employed in the state.

-- "depository" is defined as any federally-insured institution, any thrift or home financing institution which is a member of a federal home loan bank, and any other bank or thrift, which receives deposits, incorporated under the laws of any state. Foreign-owned companies which maintain branches or subsidiaries in the United States, and which receive deposits, also would constitute "depositories."

-- "business location" is defined to include the ownership and operation of an electronic funds transfer facility.

Another section of Title III would prohibit a state or political subdivision from imposing a higher rate of tax upon an out-of-state depository than would be the case if the depository had its principal office in the state.

Prior to 1969 the power of state and local governments to tax national banks was narrowly circumscribed by federal statute (12 U.S.C. §548). In 1969 Congress revised 12 U.S.C. §548 to remove previous restrictions on state taxation of national banks and to provide simply that national banks would be subject to the same tax treatment as state-chartered banks. However, Congress further provided that this principle was not to become

effective until January 1, 1972, later extended to January 1, 1973. Pursuant to a Congressional mandate, the Board of Governors of the Federal Reserve System conducted a general study of this area and submitted a report in May of 1971. One of the report s principal recommendations, which Congress adopted in 1973 in Pub. L. 93-100, was temporarily to defer the imposition of state and local "doing business" taxes on out-of-state national banks and other federally-insured depositories so that uniform and equitable methods could be developed for determining jurisdiction to tax and for dividing the tax base among the states.

This bill would adopt the "business location" test for jurisdiction to tax. A depository would be considered to have a business location in a state if it maintains an office in such state; employs one or more people in the state on a regular basis; leases to others tangible personal property located in the state or owns and uses property involved in electronic funds transfers in the state. In short, this proposed legislation would allow non-domiciliary states to tax depositories which have established business locations within their borders. No political subdivision of a state would be permitted to tax a depository unless there is a business location in the political subdivision itself Income from loans made by domestic offices of U S depositories to overseas borrowers would be included for purposes of ca culating the "doing business tax. Income from foreign branches of U.S. based institutions would be excluded from the calculation of the tax base.

The bill contains an optional formula which a state having jurisdiction may use to calculate the maximum percentage of a depository's tax base which may be taxed. The sum of the percentages in all states may not exceed 100 percent of a depository's tax base.

The formula would place equal weight on payroll and receipts The payroll factor would be calculated by dividing the total amount paid in the state by the depository as compensation by the sum of compensation paid during the taxable year in all states in which the depository is taxable.

The receipts factor would be calculated in a similar fashion. Interest from loans secured by real property would be assigned to the state where such property is located. Interest from other loans would be assigned to the state in which the loan originated. If that state does not have jurisdiction to tax, the formula allows for the receipt to be assigned to the home office state.

The Federal Reserve Board Study, referred to above, recommended that limitations be placed on the imposition of doing business taxes by foreign states on all depositories and that measures be taken to prevent discrimination between home state and foreign state banks.

While the expertise of our Office does not extend to the formulation of tax policy, we offer the following comments and trust they will be useful to the Committee.

This proposed legislation addresses the main problem inherent in the interstate taxation of both depository and non-depository institutions -- the need for assurance that the sum of the taxable base on which two or more States levy taxes will not exceed 100 percent of the institution's actual tax base. The optional formula proposed by the bill is worthy of consideration since its adoption would limit a depository's tax liability to 100 percent of its tax base. However, the very fact that the use of the formula would be optional may render it ineffective or, at best, confusing.

To quote from the Federal Reserve Board's Study of this matter, "But even where this [100 percent] limit is not exceeded, serious burdens may result when two or more states claiming jurisdiction to tax, for example, the same net income, use different rules for interstate division of the tax base and require different kinds of records and reports." Board of Governors of the Federal Reserve Board, State and Local Taxation of Banks, 92d Cong., 2d Sess. 4 (1972). The bill's legislative history provides that, in lieu of the optional formula, a state may apply its own apportionment formula or other division of base rule to divide the applicable state tax base of any depository taxable in two or more states.

We fear that, in light of the wide dispersal of state tax methods and formulas, the proposed legislation does not go far enough toward meeting the objection raised by the Federal Reserve Board. The Committee must insure that legislation it enacts does not have the unintended effect of impeding the interstate mobility of credit and monetary flows.

While the bill's uniform Federal ceiling would protect against taxation of more than 100 percent of a depository's tax base, it would not eliminate the compliance burden associated with calculating the apportionment share according to each state's apportionment formula, rules and procedures. We urge the Committee to consider adopting a mandatory apportionment procedure which would protect state interests while avoiding confusion and added expense on the part of depositories forced to comply with various state taxing procedures.

This Office supports the provision of the bill which would prohibit discriminatory tax treatment by any state or political subdivision of an out-of-state depository. In addition we are in favor of provisions of the bill which would exempt minor, incidental or occasional activities -- such as the solicitation of loans -- which would produce minimal state revenues but would impose heavy bookkeeping and compliance burdens.

In our opinion, this bill represents a constructive approach to this complex matter. We trust that these comments will be helpful to the Committee in its deliberations on this bill.

Sincerely,

John G. Heimann
Comptroller of the Currency

The Honorable
William Proxmire, Chairman,
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

AUG 2 2 1977

Honorable William Proxmire
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This responds to your recent request for a report on S. 1900, 95th Congress, the "Interstate Taxation of Depositories Act of 1977."

Prior to 1969 the power of State and local governments to tax national banks was narrowly circumscribed by Federal statute (12 U.S.C. 548). In 1969 Congress revised 12 U.S.C. 548 to remove restrictions on State taxation of national banks and to provide simply that national banks would be subject to the same tax treatment as State-chartered banks (Pub. L. 91-156). However, Congress further provided that this principle was not to become effective until January 1, 1972, later extended to January 1, 1973.

Pursuant to a congressional mandate, the Board of Governors of the Federal Reserve System conducted a general study of this area and submitted their report in May of 1971. One of the report's principal recommendations, which Congress adopted in 1973 in Pub. L. 93-100, was to temporarily defer the imposition of State and local "doing business" taxes on out-of-State national banks and other federally-insured depositories so that uniform and equitable methods could be developed for determining jurisdiction to tax and for dividing the tax base among the States.

Pub. L. 93-100 also directed the Advisory Commission on Intergovernmental Relations to make a study of all pertinent matters relating to multi-State taxation of depositories and to make a report to Congress of the results of this study and its recommendations not later than December 31, 1974. In order that Congress would have one year to consider the Commission's recommendations, Pub. L. 93-100 imposed a moratorium on interstate taxation of depositories that would have expired on January 1, 1976. Since the Commission did not submit its completed report until September 12, 1975, section 1 of Pub. L. 94-222 further extended this moratorium to September 12, 1976. A proposal to extend this moratorium to December 31, 1978 is currently pending before your Committee in the form of S. 1114, which we supported in our April 8, 1977 letter to you.

The ACIR report recommended that Federal legislation should deny State and local governments the authority to tax an out-of-State depository unless it has a regular office in that State or operates with the regular presence of employees or agents therein or owns, leases or uses tangible personal property in such State. Regarding interstate division of the tax base the ACIR recommended legislation providing that any State be permitted to tax only so much of the entire net income or other tax base of an out-of-State depository as is fairly apportioned to that State.

The provisions in S. 1900 are much more specific in some respects than the ACIR recommendations. S. 1900 states that no State or political subdivision may tax a depository based on income earned or property employed therein unless the depository maintains an office in that State, has an employee regularly present therein regularly leases tangible personal property or owns and uses tangible property involved in funds transfers in that State. S 1900 also contains a maximum uniform apportionment formula for dividing the depository's tax base In establishing such ceiling, a two-factor formula of payroll and receipts attributable to the taxing State is used. Equal weight is given to both factors. The ratio of a depository's local payroll in the taxing State to its total payroll is averaged with the ratio of its local receipts to its total receipts and the resulting percentage is applied to the depository's base, which is its net income gross receipts or capital for the taxable year as prescribed under State law. The bill would require the exclusion from a net income or gross receipts base of all revenues derived from offices located outside the United States.

Similar rules would be applied in determining the maximum "doing business" tax which could be imposed by any political subdivisions of a particular State. To prevent overtaxation at local levels, the sum of the apportionment percentages for all political subdivisions could not exceed 100 percent.

The bill would also protect out-of-State depositories, whether national or State-chartered, from being taxed at higher rates than similar domiciliary institutions so that the power to tax could not be used to impede the interstate flow of credit.

Our basic concern is that State "doing business" taxes imposed on out-of-State depositories should not unduly impede the ability of the nation s depository institutions to continue to function as a highly efficient and sensitive mechanism for gathering available savings from all sectors of the economy and channeling them to creditworthy users wherever they may be. The approach in S. 1900 would seem generally to foster this goal of maintaining a maximum degree of mobility of credit and monetary flows.

In testifying in this connection in 1972, former FDIC Chairman Frank Wille indicated that the FDIC supported the basic thrust of the Federal Reserve's recommendation that Federal legislation should be enacted to preveht nonuniform State legislation or the taxation by States of more than 100 percent of a depository's tax base. While concurring in the general objective of this type of legislation, we would defer to those with greater expertise in the area of State and local taxation as to the technical adequacy and substantive desirability of S. 1900's precise provisions -- particularly since legislation in this area would not seem to have any direct and substantial impact on tha FDIC's discharge of its functions either as insurer of bank deposits or as primary Federal supervisor of State nonmember insured banks.

Very truly yours,

(Signed) George A. LeMaistre

George A. LeMaistre
Chairman

Federal Home Loan Bank Board

320 First Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

December 2, 1977

The Honorable Thomas J. McIntyre
Chairman
Subcommittee on Financial Institutions
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter presents the Board's comments on S. 1900, the "Interstate Taxation of Depositories Act of 1977."

As the Subcommittee members know, on September 12, 1976, Public Law 93-100, which deferred the application of "doing business" taxes on Federally-insured depositories in States other than those in which such depositories have their principal office, expired. S. 1900 seeks to provide a solution to the underlying problem which gave rise to the statutory moratorium by implementing uniform Federal standards under which a State or political subdivision thereof would be able to impose a doing business tax upon a depository institution which has a business location in the jurisdiction during a taxable year.

S. 1900 is an extremely complex piece of legislation which could have a significant impact on the operations of the savings and loan industry. The legislation would permit full taxation of the tax base of every depository institution, would provide for apportionment of the tax base among those jurisdictions where the institution maintains a business presence and would prohibit nondomiciliary jurisdictions from imposing discriminatory tax rates upon out-of-state depositories. While the issues arising from many of these provisions merit the close attention of the Subcommittee, the Board will limit its attention to areas of particular concern to the development of the savings and loan industry.

Of major concern to the Board is that the authority for States to impose doing business taxes on out-of-state depositories not restrict or discourage the interstate flow of funds that is necessary to foster competition in savings and mortgage markets. In particular, doing business taxes could impede the origination or purchase of loans and thus could hamper attempts to develop further and improve the secondary market in mortgages, frustrating a major objective of Federal housing credit policies.

The provisions of S. 1900 would establish a "business location" test of tax jurisdiction by enumerating the criteria which would bring a depository under the taxing jurisdiction of a nondomiciliary State and specifically excluding activities which by themselves would not subject a depository to such tax jurisdiction. Excluded activities include acquisition of loans or interests in loans in the secondary mortgage market and certain collection and foreclosure activities with respect to such loans. These provisions are designed to assure that the normal flow of money through the buying and selling of loans or interests therein in the secondary market would not subject a depository to taxation by a nondomiciliary State. The Board supports these provisions and would like to stress their importance on the continued development of the secondary mortgage market.

A second area of Board concern is the effect of State taxation on Federal branching policies and EFT development. Federally chartered savings and loan associations presently are limited by regulation in their ability to branch across State lines. However, in the future the authority for States to impose doing business taxes may impair implementation of a policy permitting branching throughout Standard Metropolitan Statistical Areas by Federal associations. A more immediate concern in this area is the possible impact of State taxation upon the operation of electronic funds transfer systems (EFTS) which bridge State boundaries. In the Final Report of the National Commission on Electronic Fund Transfers, the Commission concluded that the States should enact reciprocal legislation that would authorize the offering of EFT services throughout interstate market areas. The Commission further recommended that Congress establish a date after which time Federally chartered depository institutions would be authorized to cross contiguous State lines to offer EFTS deposit and other services in natural market areas, regardless of whether

or not State-chartered institutions would be permitted to do so. The Subcommittee has before it a bill, S. 2293, which would implement these and other recommendations of the Commission.

Under S. 1900, the mere use of EFT facilities by a depository in a nondomiciliary State would not constitute a "business location" for tax purposes. Where use of EFTS facilities was combined with ownership of terminals, switching facilities or any other tangible property involved in funds transfer in a nondomiciliary State, a tax nexus would be created; and the receipts from extensions of credit through the use of such facilities would become subject to the apportionment formula. Since State taxation of EFT activities could be used to impede implementation of the policies recommended in the Final Report and embodied in S. 2293, it is the Board's opinion that treatment of EFT facilities for State tax purposes which does not unnecessarily burden EFT development is essential. The provisions of S. 1900 appear to be a prudent approach which would accomplish this objective.

In conclusion, the Board would like to commend the Subcommittee for its timely consideration of these issues and to thank the Subcommittee for the opportunity to present its views on this important legislation.

Respectfully,

Daniel J. Goldberg

Daniel J. Goldberg
Acting General Counsel

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

December 13, 1977

The Honorable Thomas J. McIntyre
Chairman
Subcommittee on Financial Institutions
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to respond on behalf of the Board to your request for comments concerning S. 1900, the proposed "Interstate Taxation of Depositories Act of 1977." This bill is a revision of S. 3368 which the Board previously commented on to the full Committee on June 11, 1976.

As in the case of the earlier bill, S. 1900 would deal with most of the problem areas requiring Federal legislation that are involved in applying State and local "doing business" taxes to out-of-State financial depositories conducting business across State lines. We understand that the present bill represents a reconciliation of divergent legislative proposals introduced by various interested financial trade groups in the hearings on the ACIR's recommendations regarding such taxation before the Subcommittee last year.

The attached comments on S. 1900 deal with the substantive changes from the predecessor bill. The Board reaffirms its views on the unrevised portions of the bill expressed in its June 11, 1976 letter to the Committee. We are hopeful that the many difficult issues involved in the enactment of this legislation will now be promptly resolved. Pending this outcome, however, the Board again recommends extending the expiration date of the moratorium on Interstate Taxation of Depositories. The problems

that have taken so long to resolve could be made more complex by premature State tax action.

You and your Committee are to be commended for continuing to seek a fair resolution of this important and complex matter. Unanticipated and unnecessary restrictions on the free flow of credit among States and regions would impose great burdens on our economy and be of disservice to all Americans. We appreciate the opportunity to comment on the revised bill and hope that our views will be of assistance in moving the legislation forward.

Best wishes.

Sincerely,

Arthur F. Burns

Enclosures

Comments of the Board of Governors of the
Federal Reserve System on S.1900, the
"Interstate Taxation of Depositories Act of 1977"

In making its original recommendations to the Congress regarding the need for Federal legislation governing State and local taxation of out-of-State depositories, the Board of Governors had indicated its concern regarding the potential impact of such taxation on the effective functioning of financial intermediaries in the absence of appropriate Federal safeguards. To minimize tax barriers to interstate and interregional mobility of funds and the efficient functioning of the financial system, the Board had recommended that legislation be enacted to limit the circumstances in which State and local governments could impose "doing business" taxes on depositories having their principal office in another State to situations in which the depository has "a physical presence or a pattern of sustained and substantial operations" and prescribe rules for such taxation. Such standards were recommended not only to avoid undue impediments to credit mobility from taxation itself, but also those stemming from uncertainty regarding the application of such taxes to individual depositories and from compliance burdens generally. It is mainly with these same concerns in mind that the revisions incorporated in S.1900, as compared to the earlier bill, have been evaluated.

S.1900 has revised the provisions in S.3368 setting forth the circumstances in which a State could assert jurisdiction to levy a "doing business" tax on an out-of-State depository in three respects. An office test has been substituted for ownership and leasing of real property; ownership and use of electronic funds transfer facilities

has been added as a specific criterion of a "business location" in a State, supplemented by a stipulation that mere use of such facilities owned by an independent contractor would not constitute such a business location; and the list of other activities that would be exempt from tax jurisdiction has been expanded, mainly to cover acquisition of loans or participations from an independent contractor having a "business location" in the State and to designate additional activities associated with loan administration and enforcement and the management and disposition of properties acquired through loan defaults.

These changes all move in the direction of making the bill more specific, and thus are consistent with the Board's concern for minimizing uncertainty and compliance burdens. An office test is a simpler and more direct means for determining a "business location" than ownership or leasing of real property, although the inclusion of a definition of "office" would provide additional clarity (for example, to indicate whether an office not engaged in depository operations per se, such as a records storage center, would constitute a basis for jurisdiction). Moreover, an office test is more closely attuned to the manner in which depositories operate. The EFT provisions would remove the ambiguity regarding the status of such facilities in S.3368, and also would implement the Board's recommendation in its report on that bill that mere use of out-of-State terminals be given jurisdictional immunity. Finally, the expanded list of exempt activities appears consistent with the Board's initial recommendation that certain common occurrences associated with the operation of a depository be given

specific jurisdictional immunity, following the pattern set for nonfinancial businesses in Public Law 86-272.

S.1900 also would modify the manner in which the payroll and receipts factors in the optional Federal apportionment formula are calculated. With respect to payroll, all compensation paid to an employee located in a State in which the depository is not taxable would be assigned to the State in which the principal office is located; S.3368 would have excluded such compensation from the calculation of the payroll factor in any State. Receipts from real estate loans would be assigned to the State in which the predominant part of the real property is located and receipts from all other loans would be assigned to the State where the loan originated. All receipts from loans located in a State in which the depository is not taxable would be assigned to the State in which the depository's principal office is located. S.3368 would have apportioned loan receipts on the basis of the location of the office where the loan was applied for or purchased or of the employee who solicited the loan (unless the employee was located in a State where the depository is not taxable, in which case the receipts would have been assigned to the State in which the loan was approved.)

The procedures for applying the optional apportionment formula in both S.1900 and S.3368 appear to be adequately detailed and specific. From the standpoint of their potential for minimizing uncertainty and compliance burdens, the revisions would appear to have no significant impact. While the revisions would affect State

apportionment ratios in some degree, the Board does not believe that these differences would have any significant effect on credit mobility. Moreover, the proposed assignment of payroll and loan receipts in nontaxable States to the domiciliary State probably would improve the acceptability of the legislation to some State taxing authorities.

The only remaining substantive changes of significance in S.1900 are those relating to combined reporting and the treatment of foreign-source income. S.1900 adds language to prohibit a State from requiring the inclusion of an out-of-State Edge Act corporation--a corporation organized to engage in foreign banking or financial operations--in the combined report of a depository. It also relaxes somewhat the previous comprehensive exclusion of foreign-source net income or gross receipts from the tax base subject to State and local "doing business" taxes; such exclusion would now cover only receipts or income derived from an office, branch, agency, or other fixed place of business located outside the United States.

Neither of these changes is likely to have any significant bearing on actual interstate or international mobility of credit or the ability of depositories to operate efficiently. However, both changes would have some effect on tax situs and apportionment for any depository having an out-of-State Edge Act affiliate or foreign-source income other than that derived from a foreign office. Whether the amount of tax base of a depository apportioned to a particular State would be larger or smaller under the provisions of S.1900 than under those in S.3368 would largely depend on the relative profitability of the affected foreign as compared with domestic operations

of that depository, the applicable apportionment formula, and the definition of tax base applied by the individual State. Since policies and practices regarding taxation of foreign source income vary widely among the States, the views of State tax authorities would need to be taken into account in arriving at a legislative resolution of any problems that might exist in these sections of the bill.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

STEPHEN S. GARDNER
VICE CHAIRMAN

June 11, 1976

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Proxmire:

I am pleased to respond on behalf of the Board to your request for comments regarding S. 3368, the proposed "Interstate Taxation of Depositories Act of 1976."

The proposed Act is a comprehensive legislative proposal designed to deal with the many problems that financial depositories will encounter when the Federally-imposed moratorium on multistate "doing business" taxation of such depositories is lifted. It deals with the jurisdictional, apportionment, and to some extent, the administrative issues that the Board, in its 1971 Report to the Congress, recommended be covered by Federal legislation, and it would prohibit discriminatory taxation of out-of-State depositories, a safeguard that the Board also had recommended. However, as noted below, some of the Board's recommendations would not be implemented by the legislation.

As the Committee is aware, the issues requiring legislative resolution are difficult and complex, covering not only questions of tax equity, practicality, and economic impact in a highly sensitive and vital sector of the economy, but also problems involving the appropriate roles of the Federal versus State and local governments in resolving these issues. It is unavoidable, therefore, that legislation designed to deal adequately with these problems will need to be technical and detailed, as is S. 3368. While designed specifically for financial depositories, this bill contains many provisions that are identical to or adaptations of those in S. 2080, the "Interstate Taxation Act of 1975," and other similar bills that the Congress has developed over the years for resolving the interstate taxation problems of nonfinancial businesses.

In opening the door to multistate taxation of depositories, the major concern of the Board, as stated in its 1971 Report, is that the Congress establish adequate legislative safeguards so as to avoid tax barriers to the continued free mobility of credit and money among the States. In large part the dramatic economic growth of our country has been possible because funds were free to move from capital surplus to capital deficit areas To protect that mobility the Board considers it essential to establish appropriate statutory rules governing the circumstances under which a State may assert jurisdiction to tax an out-of-State depository, the division of an institution s tax base among the various States having jurisdiction to tax and the application of various administrative procedures including the unitary business concept, combined and consolidated reporting, and out-of-State audits.

To minimize compliance burdens, confusion, uncertainty, and litigation, which could create substantial barriers to credit flows, such legislation needs to be detailed and specific. Jurisdiction to tax should be confined to circumstances in which a depository has a substantial presence in a State, and some depository activities and procedures now inherent in the processes governing the bulk of interstate lending require special safeguards. To facilitate the development of suitable rules for multistate taxation and reduce the need for litigation, a Federal administrative agency should be designated to provide regulations and interpretations.

The jurisdictional provisions in S. 3368 generally are consistent with these requirements. They require not only that a depository have a "business location" in a State to become subject to taxation in that State, but they also provide jurisdictional immunity for certain essential attributes of traditional interstate lending processes.

The bill does not deal specifically with the tax status of electronic banking facilities -- a technology that seems destined to revolutionize banking operations in the decades ahead and to bring substantial benefits to the consumer in convenience and cost saving. Under the jurisdictional rules in S. 3368, however, it seems likely that the operation of some owned or leased equipment especially terminals that disburse or receive cash, would constitute a jurisdictional nexus even though the apportionment rules apparently would attribute none of tha tax base to a State because of such operations Point-of-sale terminals, on the other hand which basically are a specialized form of communications facility are likely to be owned or leased by others and used on a shared basis, and presumably would incur no urisdictional exposure. In the Board's view, additional safeguards should be incorporated in the

legislation to provide assurance that progress in this area will not be distorted or inhibited by the threat of burdensome taxation. Such a provision might state that use by customers of POS terminals, or other terminals not owned or leased by the depository located outside the domiciliary State could not serve as a basis for a foreign State or political subdivision to assert jurisdiction to tax.

The apportionment provisions of S. 3368 do not establish standard principles and procedures as the Board had recommended. Instead, the bill would allow each State to establish its own apportionment formula, subject to a uniform Federal ceiling -- a procedure also used in S 2080 and other similar recent bills While such a ceiling would protect against taxation of more than 100 per cent of a depository s tax base it would not eliminate the compliance burden associated with calculating the apportionment share according to applicable State rules and procedures The Board recognizes that provision of an optional Federal ceiling could help to bring about considerable uniformity in State practice, but this would take time. Meanwhile State experimentation with procedures for this new area of taxation could introduce uncertainty and ambiguity into interstate operations with possible adverse consequences for credit and deposit mobility. The Board feels that a mandatory Federal apportionment procedure would protect State interests and at the same time avoid these potentially adverse developments.

The proposed Federal ceiling is based on a two-factor formula, with a payroll factor identical to that in S. 2080 and a receipts factor tailored to the operations of financial depositories. Both appear to be sufficiently detailed and specific and to be structured in a manner that will limit the creation of impediments to credit and deposit mobility. In selecting a formula consistent with that objective the Board considers it especially important to avoid the use of factors geared to the domicile of the borrower or the depositor.

With the exception of providing a rule for combined reporting, S. 3368 would not implement the Board s recommendations that the legislation prescribe rules to guide the States in their administrative procedures and designate a Federal administrative agency to provide regulations and interpretations. There would appear to be significant benefits -- to the tax collector, the taxpayer and the consumer of depository institution services -- if multistate taxation in this area were inaugurated on the basis of uniform standards uniformly interpreted.

In accordance with the Board's 1971 recommendation, S. 3368 would prohibit discriminatory tax treatment by any State or political subdivision of an out-of-State depository, and the Board recommends enactment of that provision. However, the bill does not implement the Board's recommendation for amending the Federal public debt statutes to permit interest on Federal obligations held by depositories to be included in the base of a direct tax on net income. The Board feels that such legislation would provide desirable additional flexibility for States in designing their tax structures and recommends that an amendment along these lines be included in any legislation that is enacted.

Finally, there are technical provisions of the bill on which the Board does not feel qualified to comment but which may have policy implications meriting careful consideration by the Committee. These include the exclusion of territories and possessions from coverage of the legislation; the prohibition against a nondomiciliary State requiring combined reporting that would include nondepository or certain other affiliates; and the proposed exclusion of foreign-source and certain other components from receipts and net income. In the case of the definitions of "securities" and "money market instruments," the Board believes that it would be desirable to substitute functional definitions for the proposed closed-end definitions to avoid the need for new legislation in the event that additional instruments become important in the future.

We hope that these comments will be helpful to your Committee in its deliberations on this bill.

Sincerely,

Stephen S. Gardner

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D. C. 20456

Office of the Administrator

AUG 29 1977

Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

This is in response to your letter of August 8, 1977, requesting the comments of this Agency on S.1900, a bill "to clarify the treatment of banks and other depository institutions under State and local revenue laws."

The National Credit Union Administration finds that Federally-chartered credit unions would not be subject to the provisions of this proposal. The agency has no objections to the legislation as drafted.

Sincerely,

LAWRENCE CONNELL, JR.
Administrator

ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

December 6, 1977

The Honorable Thomas J. McIntyre
Chairman
Subcommittee on Financial
Institutions
United States Senate
5300 Dirksen Senate Office
Building
Washington, D.C. 20510

Dear Chairman McIntyre:

I request that the enclosed statement from the Advisory Commission on Intergovernmental Relations be included in the record of hearings on S. 1900--95th Congress.

Sincerely yours,

John Shannon
Assistant Director
Taxation and Finance

Enclosure

COMMENTS ON S. 1900 -- 95th CONGRESS,
"THE INTERSTATE TAXATION OF DEPOSITORIES ACT OF 1977"

On behalf of the Advisory Commission on Intergovernmental Relations, I am pleased to supply the following comments on S. 1900, designated the "Interstate Taxation of Depositories Act of 1977."

This statement deals primarily with the relationship of S. 1900 to the ACIR recommendations submitted to the Congress in our report in 1975 on "State and Local 'Doing Business' Taxes on Out-of-State Financial Depositories."

We adhere to those recommendations. Our comments include points on which the bill is consistent with the ACIR proposals, policy issues presented by differences between S. 1900 and the ACIR recommendations, and, in addition, some uncertainties and ambiguities in the bill. We hope these observations will be helpful to the Subcommittee in reviewing the proposed legislation.

Our comments on S. 3368--94th, a similar bill, were published at pages 50-54 of the Hearings before your Subcommittee May 11-12, 1976. Because many provisions of S. 1900 are identical with those in the earlier bill, we incorporate here by reference those parts of our earlier statement which apply to provisions carried forward without change. Substantive differences between the two bills will be indicated to the extent that these call for some revision of our earlier statement.

Jurisdictional standard

S. 1900, like the earlier bill, proposes a uniform jurisdictional test based on a "business location" in the state or political subdivision during the taxable year, but the definition of "business location" (sec. 304) is changed materially.

A depository is deemed to have a business location in a state if (1) it maintains an office in the state; (2) one or more employees are regularly present in the state; (3) the depository regularly leases to others tangible personal property located in the state; or (4) the depository owns or uses tangible property involved in funds transfers in the state. In the case of leased tangible personal property, the business location applies only to that property.

Other sections qualify these tests or specify numerous exclusions from them. Thus, sec. 306 (b) declares that (in the absence of a wholly separate basis for business location of the employer) an employee is not considered to be located in a state or to have a regular presence there if the employee's only business activities in the state on behalf of the depository employer are any of the following:

(1) solicitation of applications for loans which are sent outside the state for approval, of deposits received and maintained at an office outside the state, and of [sales of] financial or depository services performed outside the state;

(2) making credit investigations and physical inspections and appraisals of property securing or proposed to secure a loan;

(3) the filing of a security interest; enforcement of loans by specified processes; or maintaining or defending any action or suit; and

(4) acting in a fiduciary capacity (in various specified circumstances).

In addition, a subsection captioned "Application of the general rule" (sec. 304(b)) enumerates several exceptions to the general rule--that is, circumstances which shall not, by themselves, be deemed to create a business location. These are as follows:

(1) acquisition or purchase of loans or any interest therein from independent contractors having a business location in the state;

(2) maintenance of an office in the state by independent contractors, or business activities in the state of independent contractors, including but not limited to co ecting and servicing loans and making (on behalf of the depository) physical inspections of property which secures loans or is proposed as security;

(3) making loans through or in participation with other depositories having offices in the state;

(4) various specified activities involved in administering loans or in foreclosure or other disposition of loans, including acquisition of title to property securing loans as a result of default and managing these properties; or

(5) the use of tangible property involved in funds transfers owned by independent contractors.

The concept of "independent contractor" is defined in this subsection in more detail than in S. 3368. Apparently, the provision would preclude a state's claim of taxable jurisdiction if a depository conducted activities only through a contractor serving more than one principal--whatever the magnitude of the activities and whatever intercorporate relationships might exist between the contractor and the depository.

The provision relating to properties acquired in cases of loan defaults (sec. 304(b)(4)) specify that the depository "shall pay real estate taxes on such property" and shall not hold, own, or operate it for more than five years from acquisition. The reference to real estate taxes appears to be superfluous, since such taxes are subject to state law and local levies and require no federal sanction. The time limit on ownership presumably is intended to discourage long-term holdings in such cases, thereby assuring that property is retained only as long

as necessary to assure orderly liquidation. This exception for properties acquired to protect security interests is consistent with the ACIR recommendation of 1975, in which we proposed that federal legislation should deny authority to impose a tax if the only activities or transactions of an out-of-state depository are the prosecution of remedies or other measures to protect a security interest in case of default on a loan or other indebtedness secured by property in the state. (ACIR report, p. 51.)

The bill does not include a definition of "office." A definition is needed to clarify the intent of the general jursidictional rule and the exceptions enumerated above. Moreover, to avoid uncertainty, the definition of "office" should include various kinds of workplaces other than those where deposits are accepted, checks cashed, and loans negotiated. We observed in our 1975 report that we included in the concept such places as loan production offices, regional loan offices, representative offices, service offices, and other kinds of installations. (ACIR report, p. 59.) Other installations might include credit-card offices, specialized service units (such as detached bookkeeping and computer installations, data-processing services, trust departments and services, property-leasing offices, record-storage centers, warehouses, and garages, and similar auxiliary establishments. Any one or more of these might create the "substantial physical presence" within a state which the ACIR recommended as the primary jurisdictional test (recommendation 1, p. 51, and pp. 57-59).

By including ownership and use of tangible property involved in funds transfers in a state as a test of business location, S. 1900 makes

a constructive proposal for dealing with the difficult question of remote electronic terminals and other similar devices. The ACIR omitted reference to electronic terminals from its recommendations because the future course of technological and legal development in this field is uncertain and was under study by a special commission. The report of the National Commission on Electronic Fund Transfers, released recently, does not deal directly with state tax problems, but examines and makes recommendations on a wide range of public policy issues. The proposed business-location provision in S. 1900, though restricted to devices owned and used by an out-of-state depository, would constitute a step toward the more comprehensive policy envisioned by the ACIR, as expressed in the following comments in our 1975 report:

> It is not clear ... whether remote installations will be the private instruments of individual depository companies or groups of associated users, or, as appears more likely, will operate for the most part as public utilities providing service to competing users In any event the expanding use of this technology wi raise questions sooner or later, about the degree of economic presence and ultimately, perhaps, the extent of physical presence, of out-of-state depositories in communities throughout the Nation.
>
> In the opinion of the Commission, such incidental use of public-service communication devices should not by itself const tute a taxab e nexus. However, if the use of the devices by a depository s of such magnitude that for all practical purposes it creates a substantial physical presence through which the out-of-state depository is able to provide many of the services that ordinarily would be provided by a local office or agency, the state should not be precluded by federal law from asserting jurisdiction to tax that depository on a fair share of its net income or other tax base. (ACIR report, pp. 60-61.)

In general, the jurisdictional standard in S. 1900 appears to be about the same, or perhaps a bit lower, than in S. 3368, but the detailed exceptions and limitations in this bill, like those in the earlier bill,

might shelter considerable presence in a state. The proposed tests of physical presence (or business location) are quite restrictive.

Division of base

S. 1900 follows S. 3368 in proposing an "optional" two-factor formula to establish a ceiling on the share of the tax base of any depository which may be assigned to any state. The factors are payroll and selected categories of depository receipts. S. 1900 simplifies the rules to some extent. It specifies that, in the case of the payroll factor, all compensation paid to an employee located in a state in which the depository is not taxable shall be attributed to the home-office state, rather than excluded from the calculations. In the receipts factor, income from loans secured primarily by real estate would be assigned to the state in which the predominant part of the security is located, and income from other loans to the state where the loan originated. Loan receipts from the state where the depository is not taxable would be assigned to the home-office state. In S. 3368, loan receipts were to be assigned to the office where the loan was applied for or purchased or to the place where an employee solicited the loan, except that if the employee was located in a state where the depository is not taxable, the receipts were to be assigned to the state where the loan was approved. The attribution of other receipts (such as fees, commissions, service changes and other receipts from sales of services) is unchanged, except that "lease" is substituted for "rental" of tangible property in sec. 203 (c). A special term, "participant state," is introduced to identify those states in which a depository has a business location (sec. 203 (d) and 314).

The provisions apparently would apply to the domiciliary state of the depository as well as other states in which it has a business location, thus restricting significantly the policy choices available to the home state.

Compared with the earlier bill, these changes presumably would assign a larger share of the tax base to the headquarters state of a depository without directly affecting the shares of those market states which exercise their taxing authority. Use of a two-factor formula, with the omission of a property factor generally used in state apportionment formulas for other businesses, is a controversial matter about which state taxing officials will doubtless raise questions. (The problems are discussed at pp. 63-75 in the ACIR report.)

The ACIR observed in our 1975 report that

> ... the objective of the whole process is to prorate a taxable base in such a way that the share assigned to each jurisdiction represents a reasonable approximation of its proportionate role in providing governmental benefits and services to the taxpaying business. (P. 75.)

The appropriate criteria are "that equity, uniformity, and relative simplicity are chief among the desirable characteristics for an acceptable procedure" (ibid.).

The ACIR recommended a federal statutory requirement for fair attribution and suggested that state initiatives, within this requirement, be encouraged as a means of developing an acceptable set of standards and procedures for interstate division of the tax base. The proposed two-factor formula for determining the maximum share of each state would establish a considerable degree of certainty in the apportionment process

but would restrict the permissible range of state initiatives. Choice of an equitable policy is a difficult one, on which the ACIR position has been summarized as follows:

> ... in advance of a consistent, across-the-board solution for other categories of business, the Commission does not recommend that a federal law prescribe nationwide uniformity for depositories as a separate group. (P. 69.)

Definition of tax base

As we commented in our review of S. 3368 last year, the bills do not attempt to define in detail the "net income" or other bases to which state taxes may apply. They contain partial definitions, however, by identifying certain exclusions from the base; namely, (1) dividends received from a corporation in which the depository owns at least 80% of the voting stock; and (2) income from sources outside the United States. In S. 3368, the second exclusion covered "all income which is considered income from sources outside the United States." S. 1900 narrows this provisions, limiting it to "net income or gross receipts which are derived from the conduct of business at an office, branch, agency or other fixed place of business outside the United States" (sec. 205).

The change would mean that income from foreign branches (for example) would be excluded, but income from an international division operating as part of a domestic (U.S.) depository would be included in the tax base of the domestic depository.

The bills further control the taxable base by their provisions affecting combined or consolidated reporting.

Combined reporting

Under S. 3368, a state in which a depository has a business location could require combined reporting for corporation of an affiliated group of which the depository is a member. S. 1900 would give to the depository itself the choice of making a combined report. Also, it specifies that an Edge Act corporation (a corporation organized to engage in foreign banking or financial operations) may not be included in the combined report if its principal office is outside the state (sec. 201 (c) (1)).

The bill does not specify which choice would prevail if the state and the depository make different elections.

Although the language in S. 1900, sec. 201 (c) (1), permitting the depository to make an election differs from the corresponding section in S. 3368, the effect is probably unchanged, since the earlier bill provided that any depository which is a member of an affiliated group "may elect to determine its net income, gross receipts, or capital by reference to the base and apportionment factors of all corporations of the affiliated group."

Both bills further provide in sec. 201 (c) (2) that a state may not require an out-of-state depository to combine or consolidate with the following:

(a) a corporation which is not a depository as defined in the Act;

(b) a corporation incorporated outside the United Sates; or

(c) any corporation which derives more than 90% of its income from sources outside the United States.

The exclusion of Edge Act corporations in subsection (c) (1) is subsumed in subsection (c) (2) in the more comprehensive references to corporations which are not depositories and to corporations which derive more than 90% of their income from sources outside the United States.

In sec. 310, defining affiliated corporations, the introductory language of S. 1900 differs slightly from that in S. 3368, but the substance is the same. To be members of an affiliated group for purposes of the bill, two or more corporations must be connected through stock ownership with a common owner, either corporate or noncorporate, in the following manner: (a) 80% or more of the voting stock of each member other than the common owner is owned directly by one or more of the other members; and also (b) 80% or more of the voting stock of at least one member other than the common owner is owned directly by the common owner. Although 80% ownership is a commonly accepted standard for consolidated reporting under the federal corporation tax law, it is considerably higher than the ownership test used in the Bank Holding Company Act and in various state tax laws.

In light of the recent rapid expansion in the number and operations of bank holding companies and the great variety of intercorporate relationships that has emerged, the provisions of S. 1900 in secs. 201 and 310 relating to affiliated groups and combined reporting would almost certainly limit the scope of unitary assessments as they are applied in those states in which this technique is an important part of corporate taxation generally.

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It may be noted further that, though the ACIR made no express recommendation on the question of combined reporting, our report did propose that

> there be no Congressional action which would require a state to adopt a standardized definition of taxable income in the taxation of out-of-state financial depositories,

and that states which conform to the recommended jurisdictional standard should be permitted to apply their taxes

> on a fairly apportioned or attributed part of the entire net income, receipts, property, or other tax base (p. 52, recommendation 1 and 2).

Interest on U.S. obligations

S. 1900, like the earlier bill, contains no provisions affecting the inclusion of interest on United States Government obligations in the measure of a direct tax on net income. Under present law, this interest may be included in the tax base of an indirect excise or franchise tax "measured by" or "according to" net income but may not be included in a direct tax on net income.

Because of the importance of federal obligations in the assets and earnings of depositories, both the Federal Reserve Board and the ACIR recommended that the inclusion of such income in the base of a direct net income tax be authorized by federal law, thus eliminating an existing distinction which is not based on reasons of tax policy or economic policy.

As we commented on S. 3368, omission of this provision would result in perpetuating so-called "second-structure" taxes which complicate the tax systems of many states. A provision permitting inclusion of the interest in the base of a direct tax would allow the states to simplify their tax systems. (See the ACIR report, p. 52, recommendation 3, and pp. 77-81.)

Avoidance of discrimination

S. 1900, like S. 3368, would prohibit discrimination against out-of state depositories. The proposed provision is consistent with the ACIR recommendation (ACIR report, p. 52, recommendation 4, and pp. 81-84).

Disagreements: Administrative and judicial review

Like the earlier bill, S. 1900 contains no provisions relating to the settlement of disagreements between states and taxpayers, thus leaving these matters for resolution by customary administrative agencies and procedures established by the states and by applicable judicial proceedings. This is consistent with ACIR recommendation number 6 in our 1975 report (pp. 53-54).

Tax credits

The ACIR recommended that Congress require the domiciliary state of a depository to allow certain credits for taxes payable to other states if the domiciliary state exercised its constitutional right to apply its tax to the entire net income (or receipts, capital value, or other tax base) of the business (p. 53, recommendation 5). This was a means of assuring that the entire base might be subject to taxation in one or more states while avoiding taxation of more than 100% of the base.

Except for the provisions of S. 1900 restricting the tax-base of out-of-state depositories and the scope of combined reporting, the proposed apportionment provisions in the bill may have an effect generally similar to the ACIR credit recommendation. Apparently these restrictions would apply to the domiciliary state as well as other states. The bill would assign to the principal-office state any part of the tax base that otherwise might be apportioned to states which have jurisdiction to tax but do not impose a tax.

Definition of "State" and "United States"

The phrase, "sources without the United States," is defined in sec. 312 as having the same meaning as it has in the Internal Revenue Code, with no specific citation within that voluminous Code. So broad a reference may foster some uncertainties, especially since S. 1900 is limited by its definition of "state" to the 50 states and the District of Columbia (sec. 303).

The technical explanation of S. 1900 in the Congressional Record indicates that territories and possessions are excluded from the definition of "state" to avoid inconsistency with their special treatment under the Internal Revenue Code and to avoid affecting their revenues from taxes under existing organic acts adopted by Congress. The relationship of the Internal Revenue Code provisions to territorial taxation is not clear.

As we commented on the similar definition in S. 3368, this kind of provision has wider effects which call for critical scrutiny. For example, it raises the question whether the phrases, "outside the United States" in sec. 201 (c) (2) (b) and sec. 205 (a) (2), "without the United States" in sec. 201 (c) (2) (C), and "United States" in sec. 203 (a) refer only to the 50 states and the District of Columbia or to a broader area.

Independent
BANKERS ASSOCIATION OF AMERICA
OFFICE OF THE PRESIDENT
EXECUTIVE DIRECTOR: HOWARD BELL • SECRETARY: GENE MOORE • ASSOCIATE DIRECTOR: BILL McDONALD
100 W. GRAND RIVER AVENUE, EAST LANSING, MICHIGAN 48823

November 29, 1977

The Honorable Thomas J. McIntyre
U.S. Senator
Room 105
Russell Senate Office Building
Washington, D.C. 20510

Dear Senator McIntyre:

The Subcommittee on Financial Institutions of the Senate Banking, Housing and Urban Affairs held public hearings on S. 1900, a bill to clarify the treatment of banks and other depository institutions under state and local revenue laws on November 22, 1977. The National Association of Mutual Savings and Loans and the American Bankers Association requested an opportunity to present their views in support of S. 1900. Although the Independent Bankers Association of America did not request an opportunity to present a witness in support of this important legislation, IBAA wishes to be on record in support of S. 1900.

The state and local tax liability of financial institutions involves many difficult questions peculiar to banking. The expiration of the moratorium on interstate taxation of banks imposed by P.L. 93-100 has placed bankers in the difficult position of being subjected to potential double tax liability on the same income. This uncertainty places an undue burden on interstate commerce, the growth of the American economy and the financing of both America's consumer business and agricultural needs.

S. 1900 resolves these questions of tax liability as well as is possible. The Advisory Committee on Intergovernmental Relations study of the problem, mandated by P.L. 93-100, made an important contribution to the resolution of these tax questions and underscored the complex nature of the issues.

The Independent Bankers Association of America therefore requests that Congress enact S. 1900 to eliminate this unnecessary impediment to the financial recovery of our economy.

Yours very truly,

Edward A. Trautz

Edward A. Trautz

STATEMENT OF THE
CALIFORNIA BANKERS ASSOCIATION
AT HEARINGS ON S. 1900
NOVEMBER 22, 1977

The California Bankers Association supports S. 1900, the Interstate Taxation of Depositories Act of 1977, recently introduced by the Chairman of this Subcommittee by joint request of financial industry groups. S. 1900 represents many hours of hard work by representatives of those industry groups and constitutes a good faith effort to provide reasonable federal rules governing multi-state taxation of depositories having operations in more than one state.

Until 1969, national banks were exempted from taxation outside their domiciliary state by 12 U.S.C. §548 (Rev. Statutes §5219). The effective date of this change was delayed, first to permit the Federal Reserve to study the impact of multi-state taxation on banks and later to permit the Advisory Commission on Intergovernmental Relations to review the same problems. The latest moratorium on financial depository taxation has expired with respect to fiscal years beginning after September 12, 1976. For most financial depositories, calendar year 1977 is the first such year they may become subject to the vague, conflicting and overlapping concepts of multi-state taxation applied by the several states.

The major components of S. 1900 are:

1) uniform rules governing jurisdiction to tax; and

2) a maximum two-factor formula approach to apportioning a depository's tax base among states having taxing jurisdiction over its activities.

The principal intent behind S. 1900 is to cause multi-state depositories to be subject to tax on an aggregate of 100% of the Tax Base by those states having jurisdiction to tax them. The California Bankers Association believes this intent to be fair both to the states and to the depositories.

An equally important purpose of S. 1900 is the reduction of tax administration and compliance costs of depositories. Because financial depositories have

not normally been subject to tax outside their home states, every multi-state depository will be compelled to install a new compliance system once multi-state taxation takes effect. The costs of establishing and maintaining such a system will be large in any event; they will be enormous and impossible to control if rules governing such taxation are not uniform among the states.

The California Bankers Association believes there is a legitimate pressing federal interest in enactment of S. 1900. If increased aggregate state taxes and administrative and compliance costs of financial depositories result from multi-state taxation of such institutions, one must ask what the source for payment of such increased taxes and costs will be. There are only two possible answers to this question if current lending practices of depositories are not to be altered and interstate credit flows not to be interrupted. Once the increased costs become known, financial institutions will either increase loan spreads to cover them or pay them out of bank capital. Either alternative will produce an undesirable result.

In the first instance, interest costs to the consumer and to the investing businessman will be increased. The California Bankers Association believes the Congress would be mistaken to permit an inflationary tax increase of this nature to occur. Certainly, such an event should be discouraged, particularly while our nation is still attempting to recover from the most sustained and damaging bout of peacetime inflation in its history.

Payment of such increased costs out of capital is also unwise when many economists and businessmen predict large capital shortages will be experienced by our nation in the foreseeable future. Depletion of banking capital is particularly inappropriate at a time when some critics claim it to be inadequate already. Again, there is a pressing federal interest in limiting erosion of depository capital from multi-state taxation and compliance burdens.

The problems of interstate credit flows, inflation, and the capital needs of our society are federal questions not state issues; they present a legitimate need for federal legislation in this area to which S. 1900 is a reasonable and proper response. Our current chronic inflationary and unemployment syndrome cannot be aided by the balkanization of multi-state taxation of financial depositories.

Although the principal technical discussion of S. 1900 will be left to others, one such matter raised by the Bill merits discussion. Paragraphs (c)(1) and (2) of section 201 prohibit inclusion of "Edge Act" banks organized under Section 25(a) of the Federal Reserve Act in combined reports required by states which utilize the "unitary" system for taxing income of affiliated corporate groups. Such "Edge Act" banks are set up under the Federal Reserve Act principally to assist in financing the foreign trade of the United States. Most often, such banks are subsidiaries of national banks headquartered in other states. They do not fit within the literal definition or intent behind the term "depository" used in S. 1900 because they are strictly prohibited from engaging in domestic banking and depository activities.

The activities of Edge Act banks are governed by Regulation K under the Federal Reserve Act which includes greater restrictions on loans and borrowings than apply to domestic banks. Edge Act banks report separately to the Federal Reserve Board and are treated as independent institutions for regulatory purposes.

These circumstances led the Federal Reserve to conclude, in its 1971 study of multi-state taxation of depositories, that combined unitary tax reporting would not apply to their activities. (Board of Governors of the Federal Reserve System, 92d Cong., 2d Sess., State and Local Taxation of Banks, Pts. I, II, III and IV, 496-497 (Comm. Print 1972).) A prohibition against such combinations, as provided in S. 1900, section 201(c)(1) and (2), is appropriate because 12 U.S.C. §627 (a part of 25a of the Federal Reserve Act) allows taxation of Edge Act banks only by the state in which their principal office is located. Although this rule would seem to prohibit combinations where the Edge Act bank is located outside the state (of its parent) which requires combined reporting, section 201(c)(2) of S. 1900 also applies the prohibition where the Edge Act bank is located in a state which may require combinations in the event its parent bank is located in a state which does not require or permit combined reporting. This equal treatment seems appropriate under the circumstances. In this sense, therefore, the treatment of "Edge Act" banks reflected in S. 1900 is reflective of and consistent with the present federal law governing such institutions.

Stress must also be placed on the need for dispatch in considering and enacting S. 1900. Several of the states are known to be moving in the direction

of taxing out-of-state banks. For example, the California Franchise Tax Board has recently passed a resolution aimed at seeking legislation which would impose the California corporate income tax (as opposed to the California franchise tax on banks) on all banks receiving income from California sources. Although it is not yet clear what jurisdictional rule will be applied by California in imposing its income tax on non-domiciliary banks in the event the necessary legislative change is made, the relevant case law suggests the income in question must have acquired a "business situs" within the state to become taxable by California unless the non-domiciliary bank has sufficient other activities in the state to be subject to its taxing jurisdiction. Further, there is no reason to conclude California is taking any steps to reduce or eliminate the potential double tax impact which could result from this action. The double tax effect could arise because the income in question to be taxed by California may well also be subject to tax by the depository's home state.

Nor has the California Franchise Tax Board indicated whether it would seek to impose its combined report rules on all affiliates of the depository which has income from California sources. Presumably that will be the case and, assuming it is, substantial double taxation of income sourced and generated outside California could result. Further, the ability to combine activities taking place in California with non-domiciliary banks' operations throughout the world could well mean apportionment to California of a tax base which far exceeds the income actually generated by such banks' activities in California. Should this occur, California could gain considerable increased revenues from activities taking place outside that state which may be fully taxed today.

Once actions of this type occur, and states begin to receive new revenues from non-domiciliary financial depositories, it seems clear legislation to establish uniform Federal jurisdictional and apportionment rules will become much more difficult to enact. For that reason, the moratorium on multi-state taxation of depositories, first enacted as part of Public Law 93-100, should be reimposed retroactive to all fiscal years beginning after September 12, 1976 as to which it has now expired. This action should occur concurrently with consideration of S. 1900 on its own merits. In the absence of an extension of the moratorium, the current opportunity to rationalize and simplify the highly technical, complex problems presented by multi-state

taxation of banks could well be lost until such time as real damage is done to the financial depository industry and the many customers it now serves. Indeed, S. 1900 should be amended to incorporate a moratorium back to September 12, 1976, in order to eliminate, upon its enactment any hiatus during which states might attempt to tax non-domiciliary depositories.

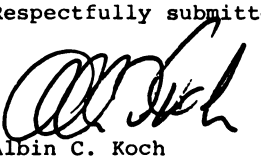
Finally, it is not at all clear that increased aggregate state "doing business" taxes for financial depositories was what Congress had in mind when Public Law 91-156 was enacted. That law was passed in response to the decision of the United States Supreme Court in First Agricultural National Bank of Berkshire County v. State Tax Commission, 392 U.S. 339 (1968). That opinion held states could not impose sales and use taxes on national banks because such taxes were not among the state taxes permitted to be imposed by old Section 5219. Because of the revenue losses that would have resulted from that decision, Congress acted at the instance of the states to remove the restrictions imposed by the existing Federal law, and that removal has now become fully effective. Congress also directed, first the Federal Reserve Board and then later, the Advisory Commission on Intergovernmental Relations (ACIR), to study the multi-state taxation problem and, in the case of the ACIR, make recommendations for "legislation which will provide equitable state taxation of out-of-state [depositories] .... [including] the matter of the proper allocation, apportionment, or other division of tax bases and ... other matters relating to the question of multi-state taxation of [depositories] ...."

Clearly, the concern of Congress was for a proper apportionment of one depository tax base among the states having jurisdiction to tax, not to permit imposition of increased taxes from overlapping multiple state tax bases.

In the absence of Congressional enactment of reasonable apportionment rules similar to those contained in S. 1900, increased aggregate state tax burdens are bound to be borne by financial depositories under the permanent amendment to Section 5219. This results because of the conflicting and complex state tax rules which prevail today throughout the United States. Such a result was not the original intent of Public Law 91-156 and should not be permitted to occur by this Committee or the Congress.

We urge your favorable consideration of S. 1900.

Respectfully submitted,



Albin C. Koch
Chairman, Tax Committee,
California Bankers Association

ACK/tk

STATE OF NEW YORK
DEPARTMENT OF
TAXATION AND FINANCE
ALBANY, N.Y. 12227

JAMES H. TULLY, JR.
COMMISSIONER OF TAXATION AND FINANCE
PRESIDENT TAX COMMISSION

November 18, 1977

The Honorable Thomas J. McIntyre
Chairman
Subcommittee on Financial Institutions
United States Senate Committee on
Banking, Housing and Urban Affairs
Room 5300
Dirksen Building
Washington, D.C. 20510

Dear Senator McIntyre:

New York is profoundly concerned about Federal legislation designed to prescribe rules for state taxation of interstate banking business. The opportunity to be heard on S-1900 is welcomed. Additional copies for the record will follow.

As you know from previous testimony by me before you and this committee on ACIR recommendations in May, 1976, New York is not opposed to Federal law providing jurisdictional rules limiting the right of states to tax out-of-state financial depositories. We recommended then, and still do, rules which approximate existing practices of the states. This would reflect state regulatory provisions which do not allow interstate branch banking. This approach would avoid significant losses of revenue to some states and windfall gains to others, while leaving to time and experience the development of reasonable rules for apportionment of income.

S-1900 is a bill which would be very detrimental to New York, primarily because of loose jurisdictional tests and the borrower oriented basis for apportioning receipts from loans and leased property.

Like the worst of the alternative proposals considered by the ACIR, it allows any depository which rents office space in another state for the sake of "maintaining an office" (S304(a)(i), and which employs one part-time employee with duties no greater than forwarding loan applications, to reduce taxable income in the principal office state by potentially enormous proportions. Even a more conservative interpretation of the business location tests of the bill allow jurisdiction to tax where a loan production office exists, as long as some activity in addition to mere solicitation of loans is carried on. Once the jurisdiction test is met, all the receipts of the depository from loans on real estate located in that state and receipts from other loans processed through offices in the state are used as a weight in assigning all types of depository income to that location, whether or not a tax is actually imposed.

While a number of other provisions of the bill are troublesome, and of serious concern to us, the use of the location of the borrower's security or an office performing minimal activities rather than reliance upon loan approval results in an estimated potential revenue loss annually of $75-100 million to the State and City of New York, and makes S-1900 untenable. This amount, or even one-half or one-quarter of it, is more than Congress should ask of any one state for the sake of uniformity in state bank tax rules.

It seems eminently more reasonable to us to return to a moratorium on out-of-state taxation of banks, than to make an 180-degree about face to a new and untried policy called for in S-1900. States have for years protected local banks from competition from larger and more up-to-date banks in money center states by prohibiting such banks from establishing branches within their jurisdictions. Services of out-of-state banks are limited to solicitation, conservation of assets obtained by foreclosure, and acting as a fiduciary. Such activities are minor and only incidental to the banking activities conducted elsewhere, and should not be the basis for taxation of a bank which is not permitted to carry on any of its principal functions within the state. A moratorium on out-of-state taxation would produce this result.

It is possible for a bill to be drafted like S-1900 which would reduce its impact on any state. If we must make a turn, let's turn

10 degrees rather than 180. For example, a combination of the two primary jurisdictional tests could be provided so that both maintenance of an office and the presence of loan approving employees exist before taxing jurisdiction is awarded. The apportionment rules relating to income from loans should be revised so they turn essentially on loan approval.

Also, the severe impact of the bill is caused, in part, by its failure to utilize a third apportionment factor reflecting the depository nature of the banking business. The bill is limited by definition to depository institutions in §302 of the bill. Thus, a third factor based on location of deposits is appropriate.

A deposits factor would assign a greater portion of bank income to the principal office state. This would reduce the importance of the borrower oriented receipts formula to a one-third weight rather than one-half, with payroll and deposits each carrying one-third weight as well.

Another approach to more reasonable apportionment rules would be to assign real estate loans partially to the state of approval of the loan and partially to the state of the real estate location. New York used such a rule for many years to divide the receipts of general business corporations for purposes of its business franchise tax, on the theory that the origin of sales, the place of manufacture, was more important than where the buyer used his purchased goods. Both property and payroll were additional factors in that formula. Similarly, the source of capital in the banking business could be given some weight by assigning some portion of all loans to the state where the loan is approved.

There is no panacea or singular correct set of rules for division of interstate income.

The above alternative rules for jurisdiction and apportionment are only illustrative of the opportunity Congress has to produce a bill which will begin to recognize the interstate character of the banking business, while still recognizing the fact that no state ever allowed banks to fully compete outside their home state. One can only ask, then, why banks should be fully subjected to taxation outside their home state.

New York is willing to assist in further developing acceptable Federal legislation, and if the Committee wishes, will later present more detailed comments and recommended modifications to S-1900.

In the interim, we believe a moratorium on taxation of depositories by states other than the principal office state should be reenacted.

Thank you.

Sincerely,

JAMES H. TULLY, JR.
Commissioner